Part I

Overview

Financial stability is vital to political, economic and social stability. Since the 1990s, many countries, including Mexico, Thailand, Indonesia, the Republic of Korea, Russia, Brazil and Argentina, have been hit by financial turmoil, resulting in huge economic losses and in some cases, triggering political and social crises. Governments of all countries and international financial organizations have been attaching increasing importance to the evaluation of financial risks and improvement of the financial stability, and focusing on enhancing capabilities to fend off financial risks and to prevent financial crises.

In the past two decades, China has achieved remarkable progress in reform, opening up and the development of its socialist market economy. It also achieved political, economic and social stability, which created a favourable macro environment for its financial stability. Chinese government attaches great importance to financial stability issues. In 2003, the government made important adjustments in the financial regulatory framework by establishing CBRC, which is responsible for the supervision and regulation of banking institutions. At the same time, amendments were made to the *Law on the PBC* aimed at a clearer and enhanced role of the PBC in preventing and mitigating financial risks as well as safeguarding financial stability. The State Council also explicitly requested the PBC to strengthen supervision and prevent systemic financial risks by making earnest efforts in the evaluation of financial stability. The PBC and various government agencies have taken seriously their remit to implement the principles and policies of the CPC Central Committee and the State Council. They have worked closely with each other to prevent and mitigate financial risks, promote reform in the financial system and maintain financial stability. Certain risks that China has been facing in the transitional period of the economic and financial system are being properly handled through improving the socialist market economy and deepening reform in the financial sector. China's financial system is generally stable and has bright prospect.

Definition, Framework and Tools for Maintaining Financial Stability

Definition of Financial Stability

Financial stability refers to a condition in which the financial system is able to function effectively in all key aspects. Under such a condition, the macro economy operates soundly, monetary and fiscal policies remain prudent and effective, financial ecosystem continues to improve, financial institutions, market and infrastructure are able to fulfil their functions such as resources allocation, risk management and payment and settlement, and more importantly, the financial system is able to function smoothly while facing internal and external shocks.

To understand financial stability correctly, the following aspects are of great concern:

- The balance of the relationship between reform, development and stability. In the process of evaluating the status of financial stability and handling financial risks, the principles laid down by the CPC Central Committee and the State Council will have to be implemented resolutely. This requires that all policies have to contribute to the goal of overall socio-political and economic stability; attention should be paid to public opinion, a comprehensive approach to evaluate the impact of financial risks on the financial, economic and political system as well as the general public, and a scientific approach to build a harmonious society are needed.

- It is essential to pay special attention to systemic risks in the financial system. The overall stability of the financial system and the normal operation of its key functions should be emphasized, focusing on preventing the spread of financial risks across industries, markets and regions.

- The balance between maintaining financial stability and preventing moral hazards should be properly handled. Financial stability does not mean the pursuit of "zero bankruptcy" among financial institutions, but to establish an exit mechanism for the nonviable institutions, strengthen market discipline and prevent moral hazards.

- It is necessary to balance the needs between financial stability and improving efficiency. Prudential supervision is a must to reduce risks in the financial system, but at the same time, excessive regulations that could lead to high operating costs, hinderance of financial innovation and financial efficiency should be avoided.

- Financial stability should be handled from a dynamic perspective. Even when the financial system is relatively stable, attention should still be placed on potential risks, and an early warning system for financial risks, as well as a financial safety net to address such risk tendencies in a timely manner should be established.

- Comprehensive observation of all aspects affecting financial stability is necessary. Emphasis should not only be placed on the stability of financial institutions and markets, but also on the impact of macroeconomic factors, financial infrastructure and financial ecosystem on financial stability.

- Adopt an analytical approach combining qualitative and quantitative assessment, theory and practice, to give a comprehensive assessment of the status of financial stability. We must make efforts to build a system of financial soundness indicators, but avoid the usage of simplified quantitative yardsticks to measure financial stability.

Box 1 Definitions of Financial Stability by the International Community

There is still no universally accepted definition of financial stability, because it is so complicated. Central banks, international organizations and other experts are now defining financial stability mainly from two perspectives.

The first approach is to define financial stability as "absence of financial instability". Due to the major divergence in the understanding of financial stability, central banks and other experts have long been avoiding a direct definition of financial stability. Roger Ferguson of the board of Governors of US Federal Reserve System, defines financial instability as "a situation characterized by: '(1) some important set of financial asset prices seem to have diverged sharply from fundamentals; and/or (2) market functioning and credit availability, domestically and perhaps internationally, have been significantly distorted; with the result that (3) aggregate spending deviates (or is likely to deviate) significantly, either above or below, from the economy's ability to produce'". John Chant of the Bank of Canada, defines financial instability as "conditions in financial markets that harm, or threaten to harm, an economy's performance through their impact on the working of the financial system". Professor Frederic Mishkin of Columbia University believes that "financial instability occurs when shocks to the financial system interfere with information flow so that the financing system can no longer do its job of channelling funds to those productive investment opportunities".

The second approach gives a direct definition to financial stability. In recent years, some central banks and other experts are trying to give financial stability a direct definition in order to facilitate the central banks in managing financial stability. Tomasso Padoa-Schioppa of the ECB is of the view that financial stability is a "condition where the financial system is able to withstand shocks without giving way to cumulative process, which impair the allocation of savings to investment opportunities and the processing of payments in the economy". Nout Wellink of the De Nederlandsche Bank believes that "a stable financial system is capable of efficiently allocating resources, and absorbing shocks, preventing them from having a disruptive effect on the real economy or on other financial systems. Also, the system itself should not be a source of shocks". Professors Kenneth Scott and George Kaufman of the Stanford University maintain that financial stability refers to the systemic stability of the financial system, rather than the stability of individual financial institutions or certain sectors within the financial industry.

The international organizations have yet to make a clear definition on financial stability. In May 1999, based on the lessons from Asian Financial Crisis, the IMF and the World Bank launched the FSAP, which provides a comprehensive evaluation and monitoring of the stability and fragility in the financial systems of the member economies and other economic entities. The basis of FSAP is standards and codes in nine areas, namely the *Code of Good Practices on Transparency in Monetary and Financial Policies*, the *Core Principles for Effective Banking Supervision*, the *Core Principles for Systemically Important Payments Systems*, the *FATF's 40 + 9 Recommendations*, the *Objectives and Principles of Securities Regulation*, the *Insurance Supervisory Principles*, the *Principles of Corporate Governance*, the *International Financial Reporting Standards* and the *International Standards on Auditing*. Based on these nine standards and codes, FSAP evaluates whether a financial system is stable with regard to various aspects such as stability and transparency in macroeconomic policies, the influence of prudential supervision on the stable operation of financial institutions and the effectiveness of financial infrastructure (including corporate governance, accounting and auditing standards). These standards and codes have reflected the understanding of international organizations on financial stability.

Framework and tools for maintaining financial stability

The central banks of most countries have had a role in maintaining financial stability since their establishment. In the recent decades, this function has been constantly strengthened and has universally become one of the major functions of central banks.

Maintaining financial stability is a systematic project that requires the joint efforts of various government agencies. According to its responsibility of fending off and mitigating financial risks and maintaining financial stability entrusted by the *Law on the PBC*, the PBC works closely with other agencies to secure financial stability. To maintain financial stability, the PBC observes the following framework (Figure 1.1).

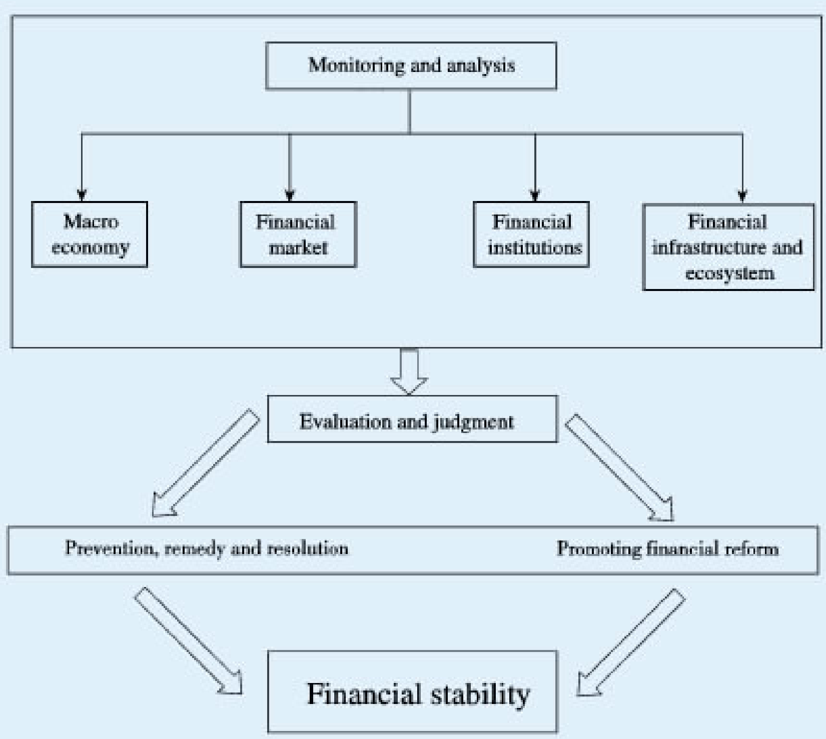
In this framework, the maintenance of financial stability covers three aspects: (1) monitor and analyse the financial risks; (2) evaluate and make judgments on the status of financial stability, take preventive, remedial and resolution measures accordingly; and (3) promote financial reform.

- The monitoring of financial risks, the obligation to follow closely and analyse the operations of the macro economy, financial markets, financial institutions, financial infrastructure, financial ecosystem and their evolution.

- Based on relevant standards and methodologies, the evaluation and judgements on the impact of the macroeconomic environment, financial institutions, market, infrastructure and ecosystem on financial stability.

- The adoption of measures accordingly. When the operating environment of the financial system is stable, attention should be paid to potential risks and preventive measures should be adopted. When the financial environment approaches the critical condition of instability, remedial measures should be taken to extend liquidity to key financial institutions that are facing liquidity problems (as their problems could have a systemic impact), but otherwise have healthy financial positions and normal business operations. Measures should then be taken to reform and restructure these institutions to ensure their healthy operation. When the financial system becomes unstable, market-oriented crisis management measures should be taken promptly to liquidate, close or restructure those financial institutions facing serious insolvency problems that make them unable to maintain normal business operations, so that market discipline is enforced, interests of investors are protected and economic and social stability is ensured. Meanwhile, timely reforms on the weak links of financial institutions, market, infrastructure and ecosystem should be implemented, and comprehensive financial reform should be adopted to promote overall financial stability.

Figure 1.1 Framework for the Maintenance of Financial Stability in China



The maintenance of financial stability requires effective policies, tools and institutions. Based on international experiences, as well as practices of the PBC and other departments in maintaining financial stability, the proper policies, tools and institutions in China's current context include: strong governmental leadership and focus, tools such as interest rates, exchange rates, liquidity support, capital account management, guidance on public opinion and moral suasion; systematic arrangements such as payment system support, rule of law support, prudential supervision, a system to protect investors and a system for the coordination of supervision. The PBC works closely with other agencies in making good use of these policies, tools and institutions to ensure financial stability.

First, strong governmental leadership and focus is the basis for maintaining financial stability. Great focus and correct policy of the CPC Central Committee and the State Council is designed to ensure financial stability; close attention and active measures by local governments and close cooperation and vigorous policy implementation by various government agencies constitute the most important foundation for financial stability in China.

Second, in line with its duty of maintaining financial stability enshrined in the *Law on the PBC*, the PBC, through the adoption of tools and systems such as interest rates, exchange rates, liquidity support, capital account management and payment system support, has helped to create a favourable environment for the healthy operation of financial institutions and markets to ensure the overall stability of the financial system. Among these tools and systems, interest rate tools means that the central bank will, in times of financial instability, adjust interest rates to stabilize bank savings and prevent large-scale capital flows. Exchange rate tools means that the central bank will provide a favourable exchange rate environment for financial stability through a prudent and forward-looking exchange rate policy. Liquidity support refers to the funding support by the central bank to financial institutions that might trigger systemic risks. Capital account management refers to the management measures adopted by the central bank to monitor cross-border capital flow and/or cope with financial panic. Payment system support is designed to ensure the normal liquidity flow between market participants by improving the payment and settlement system.

The guidance on public opinion and moral suasion is very important when symptoms of financial risks appear. Relevant agencies may communicate, openly or privately, with investors, financial institutions and relevant parties to elaborate on policy intentions and urge the financial institutions to operate in a prudent manner to prevent financial panic and maintain market confidence.

Third, maintaining financial stability also requires related agencies to intensify the construction of financial infrastructure and institutional systems, and to improve the financial ecosystem. Among these measures, legal support means to establish and improve such legal systems for investors' protection, combat financial crimes, prevent and mitigate financial risks and to ensure effective implementation. Prudential supervision requires the regulatory bodies to formulate and implement policies of prudential supervision, which is the key to ensuring stable operation of financial institutions and markets. An investors' protection system refers to the establishment of deposit insurance scheme, measures to protect interests of securities and insurance investors, and enhance their awareness of financial risks. A supervision coordination mechanism calls for the establishment of effective supervision and resolution coordination mechanism between the PBC, the MOF and other regulatory bodies, between the central and local governments and between domestic and overseas markets. To maintain financial stability, other financial infrastructure should also be strengthened, including the improvement of corporate governance, higher accounting and auditing standards and enhancement of the credit system.

Overall Assessment of China's Financial Stability

Overall, China's Financial System Is Stable, Risks due to Historical Legacy Have Been Effectively Resolved and the Comprehensive Mechanism to Maintain Financial Stability Is Taking Shape

The CPC Central Committee and the State Council have always emphasized the overriding importance of overall stability and requested that relationship between reform, development and stability be properly handled. In 2004, the CPC Central Committee and the State Council called for the fostering of a scientific approach to development, taking the sustainable development of the economy as the strategic goal and transforming the pattern of economic growth. These principles have created a favourable macro environment for China's financial stability. China has made important headway in the reform and development of financial institutions, and the risks in the financial system have been dealt with timely and a generally stable financial environment has been achieved as a result.

First, favourable political and economic environment. The appropriate external political and economic policies have created a favourable international environment for China's financial stability. Timely and effective macroeconomic management policies have mitigated the shocks due to fluctuation of the economic cycle on financial stability and the healthy development of the macro economy has provided a good domestic environment for financial stability. The exchange rate is stable due to a prudent monetary policy, which has laid a solid foundation for financial stability.

Second, stable performance of the financial market. China's money market, bond market and foreign exchange market are developing very well. The size of the markets continues to expand, the variety of financial instruments is increasing, and financial innovation is progressing smoothly. The healthy development of the financial market has facilitated financial stability.

Third, establishment of an effective mechanism for the resolution of risks in the financial institutions basically resolved the financial risks from historical legacy, and formation of market-based investors compensation mechanism and an exit mechanism for nonviable financial institutions. Under the leadership of the State Council, the PBC, the MOF and other regulatory authorities and local governments have worked together closely to push ahead the risk resolution, restructuring and reform of financial institutions. This has effectively resolved the financial risks in financial institutions such as banks, securities companies and TICs, which in turn have protected the interests of investors and enhanced public confidence in financial institutions. In the process of risk resolution, a market-based mechanism for the disposal of non-performing assets is taking shape, market discipline is improving, the risk awareness of investors is significantly enhanced, and the operations of financial institutions are improved. These developments will help to ensure financial and social stability.

Fourth, remarkable achievements in reforming financial institutions. The operating performance of the financial institutions is improving, with significant improvement in the quality of their assets; financial risks are under effective control and corporate governance further enhanced. In particular, reform in the banking institutions has made significant progress. The shareholding reform of the SOCBs has achieved remarkable success. BOC and CCB have achieved major improvements in their financial positions, with key indicators already close to those of large international commercial banks. A mechanism for modern corporate governance is starting to play its role within these banks. ICBC has basically completed financial restructuring and has been reformed into a shareholding limited liability company. Pilot programmes to reform RCCs further have been extended to 29 provinces, autonomous regions and municipalities, and the operating performance of RCCs have improved with a significantly stronger financial strength. The reform and development of banking institutions, including other SOCBs, JSCBs and city commercial banks have also made positive progress. The model and framework for restructuring and reform of securities companies have been largely established and the reform measures have achieved initial results. The reform and development of the insurance industry have made huge progress, with the restructuring of state-owned insurance companies essentially completed. At the same time, China has continued to implement its WTO commitments by expanding, both in breadth and depth, the scope of market opening in the financial industry. China's financial sector, by grasping opportunities in challenges and seeking development in reform, has begun to integrate into the international financial system and increased its international competitiveness. On the whole, China has formed a sound system of modern financial institutions with comprehensive functions, multiple structures, proper division of labour and that complement one another. Various financial institutions are building themselves into modern financial enterprises in line with the principles of capital adequacy, strict internal control, safe operation, good service and high economic efficiency.

Fifth, better financial infrastructure and ecosystem, with an improving financial stability mechanism. In financial infrastructure, the LVPS of the PBC is gradually improving, the payment and settlement system with notes and bankcards as the main tools has been established, and a clearing system with modern payment system as the core, internal system of commercial banks as the basis and the coexistence of bills exchange system has basically been formed. Significant progress has also been made in the rule of law in the financial sector, corporate governance, accounting and auditing standards for financial institutions and establishment of the credit system. Increasing importance is being placed on prudential supervision and the necessity and importance of strengthening supervision have gradually becoming a consensus. The information exchange and policy coordination among the PBC, the MOF and other regulatory authorities have been strengthened and a coordination mechanism for the supervision and resolution of financial risks is being established. Initial progress has been made in the development of the financial safety net, and the establishment of deposit insurance scheme, securities and insurance investor protection system, which has laid down the institutional foundation for financial stability.

In addition, the importance of financial ecosystem on financial stability is starting to be recognized by wider society. Chinese government has been working vigorously for a better financial ecosystem by improving the financial legal system, increasing law enforcement, accelerating the development of the credit information system, fostering the awareness of credit between enterprises and individuals, enhancing credit awareness in broader society and protecting the legitimate rights and interests of investors and financial institutions.

Issues Worth Attention to Maintain Financial Stability in China

Although China's overall financial system is stable, close attention should still be paid to existing problems in the financial system by careful evaluation, earnest prevention of financial risks and vigorously promoting financial reform. Currently, the following ten aspects should be focused in order to maintain financial stability.

First, structural transformation of China's growth pattern. China's present economic growth relies too heavily on investment and export, and the problem of uneven development exists in different areas and sectors. The investment-propelled economic growth could lead to overheating in some sectors and fluctuations in economic growth, and the contribution of exports to economic growth is vulnerable to protectionism. The major fluctuations in sectors such as real estate and steel could result in unsustainable development of enterprises. Changes in the economic environment, structural adjustment of industries, deteriorating export environment and overheating in property sectors could affect the profitability and sustainable development of the real economy, which in turn will lead to rising non-performing assets in the financial institutions and hinder the healthy operation of the financial system.

Second, the balance between direct and indirect financing. At present, direct financing in China is developing slowly, which results in a distorted relationship between direct and indirect financing. The development of the bond and stock markets is lagging behind. Financing of enterprises relies heavily on bank funding, and so banks are now bearing the risks that should belong to financial markets, resulting in the concentration of financial system risks in the banking institutions. The capital market still faces various legacy problems and structural deficiencies, namely: (1) the lack of timely and reliable information from listed companies, (2) quality and corporate governance of listed companies are needed to improve, (3) non-tradable share reform has to be completed, (4) the market-based pricing mechanism of financial assets is yet to be completely established, and (5) the supervision of securities companies must immediately be strengthened.

Third, implicit fiscal deficit. The implicit fiscal deficit as a result of lack of social security funding, debts of local governments and other problems could be transferred to the financial system, thus affecting overall financial stability.

Fourth, coping with the risks in financial regulation and liberalization. In the process of interest rate liberalization and improving exchange rate mechanism, enterprises, financial institutions, residents and other market players should adapt to a changing environment from regulation to deregulations and learn to understand and cope with interest rate and exchange rate risks. Therefore, it is necessary to build a multi-layered financial market with diversified products, develop financial derivatives, encourage financial innovation and increase the options of financial tools on risk management for market participants.

Fifth, improvement in the corporate governance of financial institutions. Corporate governance of financial institutions has such problems as insiders control, insufficient information disclosure, distorted business objectives, lack of explicit and effective risk control mechanism and market incentive mechanism, which have affected the risk management capability of financial institutions and thus prone to triggering credit and operational risks.

Sixth, risk surveillance and supervision on integrated financial services. Integrated financial services are the natural result of financial innovation and the development of the financial industry. Meanwhile, it is linked to various financial tools, reflecting complicated relationship of rights and obligations between the financial institutions and investors, and containing cross-institution, cross-market and cross-border risks. In general, investors are yet to have adequate knowledge and sufficient risk awareness regarding integrated financial services. The financial institutions are yet to establish an effective mechanism for risk prevention and internal control in such activities, leaving blind spots in supervision of certain business. Therefore, improvement is required for the overall regulatory framework.

Seventh, prevention of moral hazards in risk resolutions of financial institutions. Due to the imperfect investor-protection system and the lack of risk awareness among investors, in recent years, the government has usually been required to compensate individual investors in the process of closing down financial institutions. This arrangement will not help to enhance the risk awareness of investors or to strengthen market discipline of financial institutions, and may even lead them into over-expansion and irrational business practices. How to maintain financial stability while preventing a moral hazard in risk resolution has become a dilemma that needs to be resolved urgently.

Eighth, improvement in financial infrastructure. The market mechanism for payment service institutions is not yet completely in place, and the quality of regulation of payment and settlement services needs to be improved. The financial legal system, accounting and auditing standards, information disclosure and credit information system should be further strengthened. The financial safety net needs to be improved. The mechanism of information sharing and supervision coordination among the PBC, the MOF and other regulatory authorities needs to be better implemented.

Ninth, improvement in the financial ecosystem. External intervention on financial institution still exists. Historically, the financial system has taken up a large amount of costs in the restructuring of state-owned enterprises. In the process of the reorganization and bankruptcy of enterprises, if the rights of the banks to get back their loans cannot be ensured, the occurrence of new non-performing assets would be difficult to avoid. In addition, because of the weak credit-culture in China, such problems as a lack of creditworthiness and defaulting on bank loans occur from time to time. In spite of the existence of relevant laws, weak enforcement is affecting the financial stability and may even have repercussions on social stability.

Tenth, the spill over effect of economic and financial globalization. China's financial stability is more and more affected by the international economic and financial environment with the advance of the globalization process, and is faced with many factors out of its control, such as surging oil prices, the global rise of interest rates, fluctuations in USD exchange rates, international political turmoil, wars and regional conflicts. With the increasing participation in international production, trade and monetary system, China is also facing with increasing uncertainties and risks that come along with the benefits of globalization. Also, with financial innovation and financial liberalization further integrating the global financial system, the chance of cross-border contagion of financial risks is rising, and the financial performance and conditions of other countries are having a larger impact on China. These spillover effects have brought more uncertainties to China's financial stability.

Establishing a Long-term and Effective Mechanism of Financial Stability with Chinese Characteristics

The maintenance of financial stability is a project that requires work in many aspects. Under the leadership of the CPC Central Committee and the State Council, the PBC will work closely with other agencies, based on the principle of promoting stability through reform and development to enhance macroeconomic management, settle historical legacies properly, mitigate financial risks, optimise financial structure, facilitate reform of financial institutions, improve financial markets, infrastructure and ecosystem, and establish a long-term and effective mechanism for financial stability in line with China's national conditions, so as to maintain the sustained stability of its financial system.

First, earnestly implementing policy decisions of the CPC Central Committee and the State Council. The maintenance of financial stability is a long-term and strenuous task. The PBC and relevant agencies will earnestly implement relevant principles and policies, foster the concept of scientific development, properly handle the relationship between reform, development and stability, and address timely the tendencies affecting financial conditions so as to maintain its stability.

Second, improving the macroeconomic management system to create a favourable environment for financial stability.

- Macroeconomic managements should be strengthened to promote a stable and relatively rapid economic growth. Measures to achieve this target should include economic and legal tools, supplemented by administrative measures.
- Monetary policy should be more forward-looking, timely and effective, transmission mechanism of monetary policy should be more efficient, and more steps should be adopted to promote interest rate liberalization.
- The RMB exchange rate reform should be promoted further, in order to develop gradually a managed floating exchange rate regime based on market supply and demand, and to keep the exchange rate relatively stable at an adaptive and equilibrium level.
- Strengthen coordination between monetary and fiscal policies, prepare and enforce budget discipline, enhance transparency in the financial records of public funds, improve the ability of sustainable development of the budget, and encourage a bigger role of fiscal policy in maintaining financial stability.

Third, speeding up reform of financial institutions. The shareholding reform of SOCBs should continue, the reform of RCCs should be deepened, restructuring and consolidation of city commercial banks and UCCs should be facilitated, operation of financial assets management corporations should be based on market principles, high-risk securities companies should be reorganized, reform in the insurance industry should continue and a multi-layered system of financial institutions should be formed.

Corporate governance of financial institutions should be improved and financial product innovation should be encouraged. Ownership reform of financial institutions should be conducted to clarify the subject of ownership. Financial institutions should be encouraged to introduce strategic investors, accelerate market opening, induce active participation of the board of directors, management and market participants, and establish a system to encourage incentive discipline mechanism, promote full competition. Risk management systems should be fostered and internal controls should be improved. Financial institutions should be encouraged actively to promote product innovation and increase financial efficiency.

Fourth, promoting reform, market opening and stable development of the capital market. The capital market reform should be taken as an opportunity to properly handle historical legacy issues, build up a better system, establish a multi-layered capital market system, improve market structure and introduce more products to the market, optimise the financial structure, and facilitate the development of direct financing, so as to appropriately direct public savings from the banking system and to reduce the concentration of financial risk on the banks.

Fifth, resolving financial risks through market mechanism with a focus on preventing moral hazards. The PBC, together with the MOF, other regulatory authorities and local governments, will continue the work on risk mitigation and ensure smooth exit from market of high-risk financial institutions and prevent systemic financial risks. Meanwhile, new ways should be explored to resolve financial risks through market mechanism, in order to prevent moral hazards.

Sixth, enhancing financial infrastructure. The payment and settlement system should be modernized further. The financial legal system should be strengthened by revision and improvement of important laws such as the *Company Law of the People's Republic of China* (referred as *Company Law* below), the *Securities Law of the People's Republic of China* (referred as *Securities Law* below) and the *Law of the People's Republic of China on Enterprise Bankruptcy* (referred as *Bankruptcy Law* below). Corporate governance, accounting and auditing standards should be improved and a credit information system should be established. Efforts will be made in building a financial safety net, strengthening prudential supervision, establishing a deposit insurance scheme, securities investors protection fund and insurance protection fund, and enhancing the education and risk awareness of investors. Efforts will be introduced against money laundering and international cooperation will be deepened in this regard. More ways will be explored to set up a systematic coordination mechanism for financial supervision with the participation of the PBC, the MOF, CBRC, CSRC and CIRC. The function of the central bank as the lender of last resort should be improved further, and should be properly coordinated with monetary policy and investors' protection system.

Seventh, improving the financial ecosystem. Financial law enforcement should be reinforced, awareness of corporate governance should be enhanced, information disclosure should be in strict accordance with relevant accounting and auditing standards, credit awareness should be fostered among the general public to enable the building of a credit culture with honesty and creditworthiness. Financial supervision should be strengthened.

Eighth, Establishing and improving the theoretical system and operational framework for the supervision, evaluation and prevention of financial risks by learning from international experience. We will build up a theoretical framework for financial stability in line with China's economic condition, establish the indicators' system of financial stability and the early warning system of financial risks, improve the supervision and evaluation methods on the fragility of financial system, monitor closely the financial risks that transcend different industries, markets and regions, formulate contingency plans against various financial emergencies and set up a rapid reaction mechanism that deals with financial risks of different types, scopes and intensities.

Part II

Macro Economy and Financial Stability

Economic performance determines financial development. A sound macroeconomic environment is an important prerequisite for financial stability and healthy operations. Major economic fluctuations can have a negative impact on financial institutions' soundness and may even trigger financial risks. Generally speaking, analysis of the influence of the macro economy on financial stability is usually made through perspectives such as economic growth, currency stability, policy on and level of interest and exchange rates, balance of payments position, and fiscal income and expenditure situation. Stable and high-quality economic growth could prevent major ups and downs in the economic and financial systems, and laid a solid foundation for financial stability. Achieving a stable currency also helps to maintain financial stability. On the contrary, it will be difficult for the financial sector to develop healthily in an environment of high inflation, where activities of enterprises and financial institutions are distorted and society is unstable. An interest rate that accurately reflects the cost of capital, an exchange rate regime and policy that meets the needs of economic development, strong balance of payments and adequate foreign exchange reserves will help the economy to achieve internal and external balance, and reduce the possibility of a banking or currency crisis occurring. A level of fiscal deficit and debts that conforms to the financial capability of the government and falls within a rational scope may enhance the economy's ability to defend itself against internal and external shocks.

Since the economic reform starts, China has made significant progress in its economic restructuring, established a socialist market economy and comprehensively improved production capacity, overall national strength and people's living standard. Sustained and rapid growth of the national economy has created a good external environment and provided a solid foundation for financial reform and stability. Since 2004, China's economic growth has remained stable and relatively rapid. A prudent monetary policy was effectively implemented, the rapid investment growth has been contained to some extent, consumption and incomes have grown steadily, inflationary pressure has reduced, regulation in the real estate market has shown some initial results, exports have increased rapidly, grain production has shown good momentum, and economic restructuring has made new progress. Internationally, world economy and global financial systems have performed smoothly, with the global financial environment remaining stable. The proactive and prudent reforms of the RMB exchange rate mechanism, favorable balance of payments, adequate foreign exchange reserves and the policy of gradual liberalization of the capital and financial accounts have offered a good international environment for China's financial stability.

In order to continuously create a favorable macroeconomic environment, we need to further set up and implement the concept of the scientific development, speed up the reform of the economic system and transform the pattern of economic growth, step up efforts in economic restructuring and promote a coordinated development of the financial system. We prepare to apply comprehensive economic and legal tools to strengthen and improve macro regulation and promote the stable operation of the economy. We should pay close attention to the changes in the international economic and financial environment, and to the negative impact of such factors as rising USD interest rates, surging oil prices and international economic friction on global financial stability. We also need to study the influence of globalization, international economic restructuring, international capital flow, the changing environment for exchange rates and the pressure of trade protectionism on China's financial stability.

Macroeconomic Performance

China's stable economic performance, sustained and rapid economic growth and the improving macroeconomic management have laid a solid foundation and created a favorable environment for its financial stability. At the same time, we still need to pay attention to the influence of economic growth pattern and economic and financial structure on the healthy development of the financial system.

Stable and Relatively Fast Economic Growth Has Laid a Solid Foundation for Financial Stability

Stable and Relatively Fast Growth of the National Economy

Since the 3rd Plenary Session of the 11th CPC Central Committee when the reforms and opening up of China's economy began, the 14th National Congress of CPC when the goals for setting up the socialist market economic system were established; and the 3rd Plenary Session of the 16th CPC Central Committee when the *Decision* was issued, China has made important progress in both theory and practice of economic reform and has initially established a socialist market economic system. The deepening reforms have significantly improved production capacity, overall national strength and people's living standard, and ensured that China has been able to withstand the severe tests of international economic and financial turbulence, as well as the grave natural disasters and major epidemics in the country.

In the 27 years from 1978 to 2004, China's economy grew at an annual average rate of 9.4%—the fastest and longest-sustained economic growth in the world during this period. China's economy sustained rapid growth, economic efficiency was greatly enhanced, structural adjustment obtained new development, and the capability of economic growth was strengthened. Urban and rural residents' income grew continuously. The proportion of fiscal income to GDP has continued to rise. Imports and exports increased rapidly. Foreign exchange reserves increased significantly and RMB currency value remained stable. The actual inflow of foreign investment grew steadily. Both domestic and external debts are within safety limits.

Since 2004, China's economy has maintained stable and relatively fast growth, with further enhanced overall national strength. The reforms have made important progress and the opening up of the economy achieved new breakthroughs. The development of social undertakings has been accelerated and people's living standard has continued to improve. In 2004, China's GDP reached RMB13.65 trillion yuan, up 9.5%; fiscal revenue reached RMB2.63 trillion yuan, up 21.4%; total retail sale of consumer goods reached RMB5.4 trillion yuan, up 13.3%; imports and exports reached USD1.15 trillion, up 35.7% and China ranked as the 3rd largest trading nation, up from the 4th in the previous year; an additional 9.8 million people were employed in urban areas, exceeding the target; the per-capita disposable income of urban dwellers and the per-capita net income of peasants grew 7.7% and 6.8% in real terms, respectively. In the first half of 2005, China's economy maintained stable and relatively fast growth. The good performance of the national economy provides a solid foundation for promoting financial system reforms and maintaining financial stability.

Implementing the Concept of Scientific Development, and Strengthening and Improving Macroeconomic Management

The concept of scientific development is a new development philosophy within the guiding principles of the CPC as part of its socialist modernization drive. It further highlights the paramount importance of development, and urges us to concentrate on economic development and endeavor to improve the quality and efficiency in economic growth. It also calls upon us to adopt a people-oriented approach, paying attention to the "five coordinations" (namely balancing urban and rural development, development among regions, economic and social development, development of man and nature, and domestic development and opening up to the rest of the world), so as to achieve comprehensive, coordinated and sustainable development of the economy and society. The macroeconomic management in the past two years is an important measure in implementing the concept of scientific development. Both macroeconomic managements and market mechanisms are important components of the socialist market economy. While giving a greater role to the market in allocating resources, we must also pay attention to strengthening and improving macroeconomic managements. In the process of implementing macroeconomic managements, the CPC Central Committee and the State Council have, according to the changes in economic operations, better managing the direction, focus, timing and intensity, improved the implementation of macroeconomic management by relying mainly on economic and legal measures, supplemented by administrative means when necessary, and promoted the stability and sustained rapid growth of the economy.

Since 2004, some new problems have emerged in China's economic development, including the balance of grain supply and demand, the excessive growth of fixed-asset investments, rapid growth of money supply and bank loans, and tight supply of coal, electricity, oil and transportation. If left unattended, regional and sectoral problems may affect the overall national economy. After careful analysis of this situation, the CPC Central Committee and the State Council made a timely decision and arrangement to strengthen macroeconomic management. According to the principles, while taking good care of timing, intensity and differential treatment in different sectors, it focused on resolving prominent issues that were affecting the stable and rapid growth of the economy. Through joint efforts in all sectors of society, macroeconomic management has achieved tangible results. At present, the momentum of the excessive growth in investment has, to some extent, been contained, personal income and consumption of residents have grown steadily, inflationary pressure has reduced, regulation in the real estate market has gained initial results, exports have increased rapidly, grain production has seen positive momentum, industrial sectors have continued to grow at a fast pace, and restructuring has made new progress. Unstable and unhealthy factors in the economy have been contained, weaknesses have been eliminated, and dramatic ups and downs in the economy have been avoided—together they offer a good economic environment for the maintenance of financial stability.

Aspects Worth Attention in Macroeconomic Performance

So far, there is no universally accepted framework to analyze the influence of macro economy on financial stability. With reference to the universally adopted codes and evaluation methods of FASP and based on China's reality, in order to maintain financial stability, we should continue to pay attention to several aspects, including economic growth pattern, economic and financial structure.

Transformation of Economic Growth Pattern

China's current economic growth is still heavily based on input of key factors of production. The growth has long been relying excessively on investment and export, with a high rate of savings and investment and low rate of consumption.

Since the mid-1980s, one key feature of China's economic growth is that it has always been driven by investment demand. On the one hand, investment rate (as % of GDP) increased from 38% in 2001 to 51% in 2004, and remained high for the first half of 2005. On the other hand, the efficiency of investment was low. This pattern of investment-driven economic growth has made the problem of shortage of energy and resources still prominent. Compared with a growth pattern that focuses on quality improvement, the investment-driven economic growth pattern is more likely to result in drastic economic fluctuations, and may increase the non-performing assets of the banking system which exert negative impact on financial stability.

As one of the pillar industries of China's economic growth, real estate industry may boost domestic demand, increase consumption, accelerate the urbanization process and play an important role in facilitating all-round economic and social development. Meanwhile, attention should also be paid to the impact of major fluctuations in real estate investment on healthy economic and financial development. Since 1992, investment in China's real estate industry has undergone three stages. The first was from February 1992 to July 1995. Before the macroeconomic management in 1993, real estate investment grew rapidly, with the highest growth rate being 147%. After 1993, real estate investment growth slowed down dramatically, reaching the trough in July 1995. The second stage was from August 1995 to December 1997, when the real estate industry entered a consolidation period. The third period was from 1998 onwards. In line with the reform of the housing system, with the cancellation of the actual distribution of house in 1998 and the implementation of the policy on housing mortgage loans in 2000, investment in the real estate sector increased rapidly, maintaining an annual growth rate of 30% and above. Real estate investment has, to a large extent, relied on bank loans for financing. The fluctuation in property prices in some regions may result in a decline in the asset quality of the banking system. In addition, the fiscal revenue of certain local governments was deeply influenced by the real estate sector, making their budget and financial system very vulnerable.

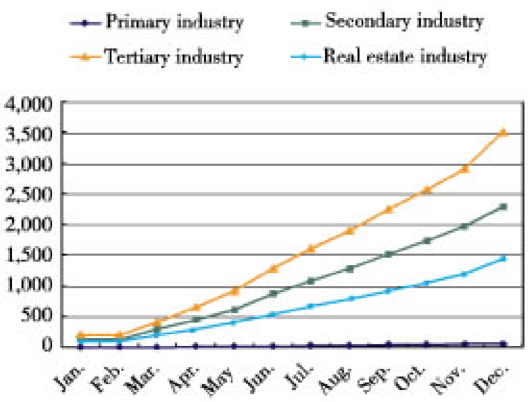
The high degree of contribution by exports is another important feature of China's economic growth. On the one hand, exports play an important role in driving economic growth, promoting and increasing employment and facilitating the formation and growth of an open economy. On the other hand, the economic growth pattern, which relies to a large extent on exports, has further aggravated the imbalance of the economic structure and the shortage of raw materials and energy domestically, which in turn has affected the ability of the economy to defend itself against external shocks. In the first half of 2005, economic growth relied more on exports, which grew by 32.7% compared with 14% growth in imports, bringing a trade surplus of USD39.6 billion, which expanded by USD47.2 billion compared with the same period of last year. Net exports have been contributing increasingly to economic growth. In addition, given the mounting surplus in China's trade with the US and the expanding surplus in its overall trade, anti-dumping cases against China increased significantly and trade fictions escalated. If domestic consumption and demand are not able to keep up with this trend, balanced growth of the economy might not be sustainable, which is not helpful for financial stability.

Optimization of Economic Structure

In terms of industrial structure, investment has been concentrated in secondary industry, while primary and tertiary industry facing with a shortage of funds. The allocation of investment in three industries in 2004 (Figure 2.1) shows that, excluding real estate investment in tertiary industry, investment in secondary industry was larger than that of the tertiary industry and far outweighed that of primary industry. Under an economic growth pattern driven by input of essential factors, capital and labor force need to be more rationally allocated in three main industries in order to enhance the ability of the economy to defend itself against internal and external shocks.

Figure 2.1 Investment in Three Main Industries and the Real Estate Sector, 2004

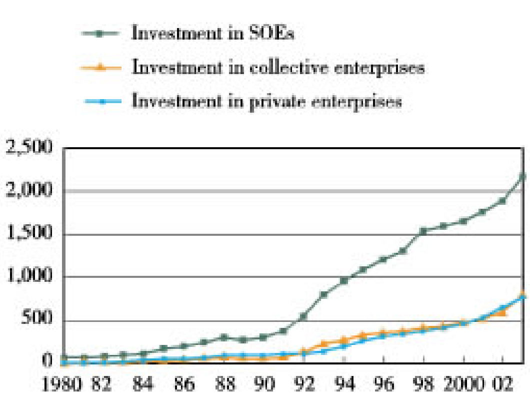
(billions of RMB yuan)



Source: CEIC.

Figure 2.2 Total Investment in Enterprises with Different Ownership

(billions of RMB yuan)



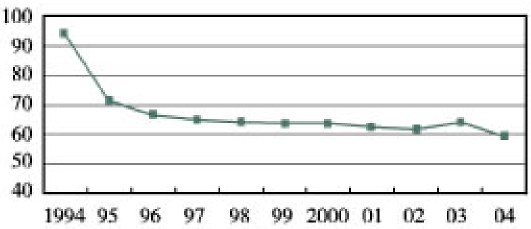
Source: CEIC.

In terms of ownership structure, total investment in the SOEs far exceeded that in collective and private enterprises (Figure 2.2). However, non-state-owned enterprises are playing an ever-increasing role in China's economic development, and their operating efficiency is also better than that of the SOEs. In the entire economy, the allocation of financial resources has not yet given adequate support to market players with higher efficiency. In the long term, the low efficiency in the allocation of financial resources is unfavorable for financial stability.

In terms of regions, investment has been mainly concentrated in the eight regions: six southeastern coastal provinces and municipalities plus the Beijing-Tianjin Area (Figure 2.3). Such imbalance of investment among regions is not conducive to the coordinated development of the national economy and financial stability. In recent years, the CPC Central Committee and the State Council, in order to ensure the sustained and coordinated development of the national economy, has implemented the strategies of developing China's West and reinvigorating its Northeast by adopting a series of policy measures and conducting regional restructuring of the economy. In 2004, the proportion of total investment in these eight provinces and municipalities went down below 60%. Some regions with inadequate investment are making efforts to improve their own financial and investment environment so as to attract more investment through market forces.

Figure 2 . 3 Percentage of Total Investment in the Eight Provinces and Municipalities

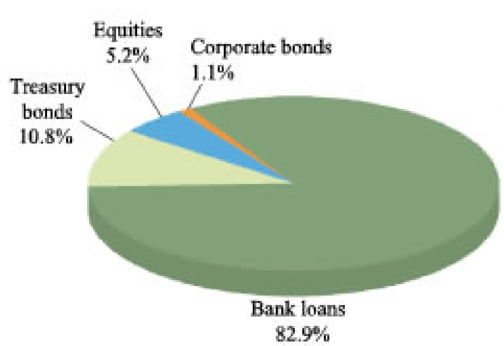
(*percent*)



Note: The eight provinces and municipalities include Guangdong, Fujian, Zhejiang, Shanghai, Jiangsu, Shandong, Beijing and Tianjin.

Source: CEIC.

Figure 2 . 4 Sources of Funding for Domestic Non-financial Sectors



Source: The PBC Statistical Yearbook, National Bureau of Statistics.

The Coordinated Development of the Financial Structure

A well-coordinated financial structure is a necessary condition for stable economic and financial performance, and has a direct bearing on financial stability. Currently, the development of direct financing and indirect financing in China is not well coordinated, with enterprises relying excessively on bank loans, and the banks are burdened with excessive risks. In 2004, for China's non-financial sectors (including households, enterprises and government agencies), the proportion of the four alternatives of financing, namely bank loans, treasury bonds, equities (funds raised by listed companies) and corporate bonds was 82.9 : 10.8 : 5.2 : 1.1, with a total value of RMB 2.4 trillion yuan (including RMB and foreign currencies) (Figure 2.4). Although the proportion of financing through bank loans has decreased and that of treasury bonds and equities increased, the level of indirect financing is still too high.

The consequence of this imbalanced financial structure is that public savings cannot be effectively channelled to investments, the market cannot fully play its role in resource allocation, and therefore it is not helpful for enterprises to manage assets and liabilities and control risks. To promote the coordinated development between direct and indirect financing, we should further deepen reform in the capital market, facilitate the development of direct financing, particularly the reform and development of the equities and bond markets, so as to satisfy the financing needs of the enterprises and divert risks from the banks.

Monetary Policy

The *Law on the PBC* stipulates that the PBC should, under the guidance of the State Council, formulate and implement monetary policy, fend off and mitigate financial risks, and maintain financial stability. Formulating and implementing monetary policy and maintaining financial stability are the legal responsibilities of the PBC. In the market economic system, monetary policy and financial stability are mutually reinforcing and closely related.

Monetary Policy and Financial Stability

Achieving the goals of monetary policy helps to maintain financial stability. The goals of the monetary policy are to maintain a stable currency value. This means that it needs to prevent inflation domestically and maintain a stable exchange rate within a reasonable band internationally. Relatively low and stable inflation may provide market players with stable expectations, support the normal operation of the real economy and create favorable conditions for the sustained and healthy development of the economy and the financial sector. A scientific and effective monetary policy helps to achieve the goals of monetary policy and maintain financial stability.

Financial stability may help to achieve the goals of monetary policy as well. Financial stability is the basis and guarantee for the stability of the currency value, and a stable currency value is an important reflection of financial stability. The sound operation of financial institutions and financial markets helps to improve the transmission mechanism and the effectiveness of monetary policy and facilitate the realization of its goals.

A sound Monetary Policy Has Created a Favorable Environment for Financial Stability

Since 2003, China's domestic economy has displayed positive momentum in terms of faster growth, better efficiency and stronger vitality. In particular, since the second half of 2003, economic growth has accelerated remarkably. The economy has maintained a growth rate of 9% or more from the third quarter of 2003 to the first quarter of 2004. With fast economic growth, there were also some problems affecting the healthy economic and financial development, such as irrational and redundant construction in certain sectors, emerging bottleneck in energy and transportation and the growing pressure of inflation. Against such a backdrop, the PBC has, under the guidance of the CPC Central Committee and the State Council, adhered to a sound monetary policy, and on the basis of coordination and cooperation with other macroeconomic policies, adopted a series of monetary policy measures including tightening monetary and credit issuance, strengthening control on monetary aggregates, differential treatment to different sectors and paying attention to optimizing the economic structure.

First, strengthening management on money and credit aggregates, containing the money and credit expansion of the banking institutions, keeping the monetary aggregates at an appropriate level, rationalizing the structure and smoothing changes of liquidity, and maintaining interest rate stable in the money market. After getting approved by the State Council, the PBC issued the *Notice on Further Strengthening Management of Real Estate Credit* in June 2003 , which offered risk signals to real estate credit in order to further standardize the development of the real estate credit market. After lifting the required reserve ratio by one percentage point in September 2003, the PBC again raised the ratio by 0.5 percentage points on April 25, 2004, and started to implement a floating interest rate system for central bank lending from March 25, 2004, the differentiated required reserve ratio system from April 25, 2004, and the policy on individual housing loans from March 17, 2005. The implementation of the above monetary policies has created favorable conditions for the stable operation of the financial system.

Second, adhering to the market approach, steadily promoting the reform of a market-based interest rate, focusing on enhancing the regulatory mechanism, with the market as the basis, and strengthening the basic role of the financial market in the allocation of resources. Approved by the State Council, the PBC decided to raise the benchmark interest rate for deposits and loans of financial institutions from October 29, 2004. The one-year benchmark interest rate for savings and loans in financial institutions was up 0.27 percentage points, and the interest rate for savings and loans at other levels was adjusted accordingly, in which the margin of increase for medium- and long-term savings and loans was higher than that of the short-term. The PBC has, in adjusting its interest rate policy, given full consideration to the development needs of commercial banks, and through retaining an adequate spread, provided conditions for commercial banks to expand their profitability, reducing non-performing assets by profit accumulation and improved their ability to defend themselves against financial risks.

Third, strengthening window-guidance, timely conveying to financial institutions the intentions of macroeconomic management through risk warnings, facilitating them in stepping up the management of assets and liabilities and optimizing the credit structure, and encouraging them to provide loans to support agriculture, SMEs, consumption, employment and education. According to the guidance of the State Council, the PBC issued a circular on January 18, 2004, urging commercial banks to adopt effective measures to strictly control loans to "overheated" industries such as steel, electrolytic aluminum and cement, set up and improve the preemptive control system for credit risks in key regions, industries and sectors, which effectively promoted balanced economic and financial development.

Fourth, vigorously promoting system and product innovation in the financial market and market infrastructure, and ensuring the safe operation of the money market by promoting market-oriented fund-raising activities by policy banks and facilitating commercial banks to set up the AMCs.

The implementation of the above monetary policies has achieved remarkable results in promoting the stable economic and financial performance and maintaining financial stability.

First, the growth of money supply was generally stable and growth of loans was moderate. The growth of M2 and M1 was generally controlled at a reasonable level, and money supply has met the needs of China's economic development. In the first half of 2005, growth of money supply and loans was generally stable. By the end of June, M2, M1 and RMB loans in financial institutions grew by 15.7%, 11.3% and 13.3% respectively. This level of growth has not only supported the stable and healthy development of the economy but also helped to contain the excessive growth rate of investment in fixed assets as well as inflation, and is generally consistent with the goal of macroeconomic management.

Second, the proper level of liquidity in the banking institutions and the adequate positions of the financial institutions have not only satisfied the need of rational growth in loans, but also prevented major fluctuations in the money market. The interest rate of the money market remained stable in general.

Third, financial institutions have adopted a floating lending rate, enhancing risk awareness in determining interest rates. The pricing of loans has also been moving towards better prevention of risks. This trend shows that the policy effect of market-based interest rates has gradually appeared and the ability of financial institutions to support economic growth has been enhanced.

Financial Stability Has Helped to Achieve the Goals of Monetary Policy

In recent years, the PBC has, together with the other government agencies, adopted vigorous measures to fend off and mitigate financial risks, promote reform in financial institutions, maintain financial stability and create a favorable environment for achieving the goals of monetary policy.

First, the reform of financial institutions has ensured their healthy performance as well as the enhancement of a better transmission mechanism for monetary policy. The reform of SOCBs, JSCBs, UCCs and RCCs has greatly improved the stability of financial institutions and the effectiveness of monetary policy, and helped to achieve the goals of monetary policy.

Second, in the process of financial restructuring during the pilot program of shareholding reform of SOCBs, the PBC has, through certain arrangements, properly resolved the possible impact of financial restructuring on money supply. (1) The foreign exchange capital injected in the banks can only be used overseas and there is a restriction on them in converting these foreign currencies into RMB. (2) For the central bank loans to the AMCs in helping them to acquire the NPLs from the state owned banks under the pilot program, the

PBC has purchased them totally by issuing five-year central bank bills to these banks, offsetting the monetary expansion impact from enlarging the base money. The reform of the financial institutions has effectively avoided financial restructuring having an impact on monetary policy and created good external conditions for the PBC to achieve the goals of monetary policy.

In summary, the sound monetary policy has played an important role in successfully achieving the goals of macroeconomic management and maintaining financial stability. The policy measures to maintain financial stability have also created favorable conditions to achieve the goals of monetary policy. The PBC will further establish and implement the concept of scientific development, pay attention to enhancing and improving financial macro management, better control the aggregates, encourage financial institutions to step up credit restructuring, promote financial reform, avoid drastic fluctuations in the economy, fend off and mitigate financial risks and effectively maintain financial stability.

Exchange Rate Regime, Balance of Payments and Capital Flows

To establish and improve the socialist market economic system and give greater scope to the basic role of the market in resources allocation, the PBC has timely adjusted the band of exchange rates based on market supply and demand with reference to a basket of currencies, maintain the RMB exchange rate basically stable at an adaptive and equilibrium level, promoted basic equilibrium of the balance of payments, actively and effectively managed capital flow and safeguarded the stability of the macro economy and financial market.

Exchange Rate Regime and Financial Stability

To reform the RMB exchange rate regime is a requirement for establishing and strengthening the socialist market economic system in China, it also represents an important component of the overall program to deepen the economic system reform and improve the macroeconomic management mechanism. It serves to implement a scientific approach to development and promote comprehensive, coordinated and sustainable social and economic development. It helps to ease trade imbalances, boost domestic demand, enhance the international competitiveness of China's enterprises, and increase the level of opening up of the economy. It also facilitates the implementation of the strategy of sustainable economic growth, driven mainly by domestic demand, the optimization of resources allocation and the improvement of the economic structure. Lastly, it is conducive to greater independency of monetary policy, more proactive and effective financial oversight and greater capacity for the economic system to cope with risks and shocks.

In accordance with the market's maturity and overall economic and financial landscape, Chinese government has been pushing ahead with the reform of the mechanism for forming the RMB exchange rate in an active but prudent manner. In 1994, the reform for the unification of exchange rate was launched, whereby enterprises and individuals could trade foreign exchanges with banks—which then traded in the inter-bank foreign exchange market to form a market exchange rate. The PBC would set a certain floating band for the exchange rate and maintain a stable RMB exchange rate by regulating the market. Experiences have proved that such an exchange rate regime has been consistent with China's national conditions and thus has made positive contributions to the sustained and fast growth of the economy as well as to the regional and world economic and financial stability. Before 1997, the RMB exchange rate remained stable with a slightly rising trend, prompting growing confidence in the RMB both at home and abroad. When the Asian Financial Crisis began, in order to avoid a deepening crisis, triggered by successive devaluation of currencies in neighboring countries and regions, China, as a responsible big country, took the initiative to narrow the band of the RMB exchange rate. As the impact of this financial crisis gradually weakened, China was witnessing sustained, steady and rapid economic growth, deeper economic restructuring, new headway in financial reform, a further easing of restrictions on foreign exchanges, and expansion in both depth and scope in fostering a foreign exchange market. All these have created the right conditions for the reform of the RMB exchange rate regime.

It is against this backdrop that on July 21, 2005, China reformed the exchange rate regime by adopting a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. Instead of pegging to the USD, the RMB exchange rate will be determined based on a basket of certain major currencies with assigned weights selected in line with the real situation of China's external sector development. At the same time, proper measures could be taken to manage and adjust the RMB exchange rate based on market supply and demand, and in accordance with the domestic and international economic and financial developments with reference to the exchange rate indices of the basket currencies, as an effort to maintain the RMB exchange rate basically stable at an adaptive and equilibrium level. Reference to a basket of currencies indicates that the RMB exchange rate could be affected by the exchange rate changes between the foreign currencies, but not necessarily a peg of RMB to the currency basket. The managed floating exchange rate regime must also be based on another important factor which is the situation of market supply and demand. According to calculations of the exchange rate at an adaptive and equilibrium level, the RMB appreciated by 2% to RMB8.11 yuan per USD on the date that the reform was publicly announced. This adjustment was determined in consideration of the size of the trade surplus and the needs of restructuring of China's foreign trade, while at the same time taking into account the adaptability of domestic enterprises to such restructuring.

The reform of the RMB exchange rate regime will have a certain impact on economic growth and employment in the short run, but broadly speaking, the benefits outweigh the cost. China will press ahead with the reform of the RMB exchange rate regime in a prudent way, create favorable conditions and guide enterprises to strengthen restructuring so as to transit smoothly throughout the reform period. Banking institutions and foreign exchange administration agencies should further improve financial services and strengthen foreign exchange administration to provide strong support for the development of enterprises. The enterprises should also accelerate restructuring and transform operational mechanisms in a bid to improve responsiveness to the reform of the exchange rate regime and to the movements of the exchange rates.

In short, the overall goal of the reform of the RMB exchange rate regime is to establish and improve a managed floating exchange rate regime, based on market supply and demand, and maintain the RMB exchange rate basically stable at an adaptive and equilibrium level. This reform must be conducted in a self-initiated, controllable and gradual way. Chinese government has always been adopting an independent and highly responsible attitude on the issue of RMB exchange rate by proceeding from the fundamental interest and economic and social realities of China, and adopting the exchange rate regime and exchange rate policies that are suitable to China's specific conditions.

"Twin Surpluses" of Balance of Payments and Financial Stability

"Twin surpluses" of balance of payments refers to a situation where an economy records a surplus under both current and capital accounts (excluding changes in international reserves) within a certain period of time. Between 2000 and 2004, China's "twin surpluses" in balance of payments kept rising (Table 2.1). Since the start of 2005, the figure continues to grow. In the first half of 2005, the balance between the sale and purchase of foreign exchange by banks produced a surplus of USD121.7 billion, a y-o-y increase of 93%. By the end of June, China's foreign exchange reserves reached USD711 billion, USD101.1 billion more than the beginning of the year, USD33.8 billion more than the increase in foreign exchange reserves in the first half of 2004.

Table 2.1 "Twin Surpluses" in China's Balance of Payments in Recent Years

(billions of USD)

	2000	2001	2002	2003	2004
Balance under Current Account	20.519	17.405	35.422	45.875	68.659
Balance under Capital and Financial Account	1.922	34.775	32.291	52.726	110.660
Total	22.441	52.180	67.713	98.601	179.319

Source: SAFE, *China Balance of Payment Statistics*, 2000-04.

Generally speaking, "twin surpluses" in balance of payments has a certain impact on a country's financial stability and thus calls for attention. First, "twin surpluses" means that the amount of RMB needed to be issued to accommodate the increase of the foreign exchange is becoming larger, which may exert pressure on monetary policy. As foreign exchange reserves continue to grow rapidly, the central bank faces pressure in sterilization operation and choice of relevant monetary policy. Second, it brings difficulties to further liberalize the capital account. With "twin surpluses" in place, capital flows will register a rapid increase both in scale and speed when the capital account gradually liberalizes, which may create asset bubbles and cause certain financial risks.

Capital Flows and Financial Stability

In the gradual process of liberalizing the capital account, attention must be paid to the impact of capital flows, short-term ones in particular, on financial stability.

International Experiences of the Impact of Short-term Capital Flows on Financial Stability

The international financial crises that have occurred frequently since the 1990s show that rapid and large scale capital inflows and outflows within a short period of time could bring a negative consequence.

First, short-term capital inflows create a false sense of prosperity that covers up potential financial risks. In the event of a crisis, capital withdrawal will inevitably lead to economic concussion. The Asian Financial Crisis is an example of the impact of short-term capital flows on the economy.

Second, short-term capital flows of large volume, especially those for speculative purposes, usually go to non-trade sectors and cause swelling asset bubbles in the form of rising prices of non-trade items, such as stocks and property, as well as growing foreign exchange reserves. The consequent distortion in resources allocation, imbalance in economic structure and increased inflationary pressures will easily trigger an economic and financial crisis.

Third, short-term capital inflows and outflows in large volume may cause big fluctuations in foreign exchange reserves as well as drastic changes in supply and demand in the foreign exchange market, which will in turn result in swings of exchange rates. The speculative activities of short-term capital flows add to uncertainty in the market. In the mean time, large short-term capital inflows will also lead to a maturity mismatch between the funding source and domestic investment, and thus affect financial stability.

Finally, frequent short-term capital flows make it more difficult for countries to manage their monetary policy and therefore affect the independency and effectiveness of monetary policy.

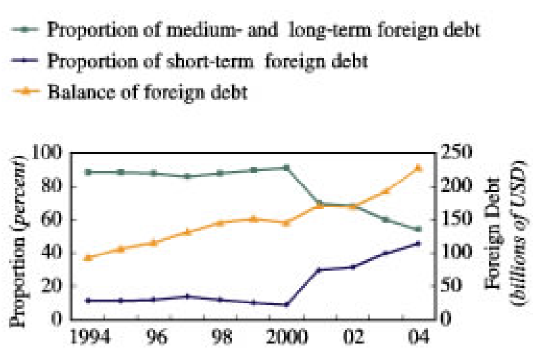
Short-term Capital Flows in China in Recent Years and an Analysis of the Cause

On balance, cross-border capital flows in

China consist of two parts. One is FDI and overseas investment of China's enterprises. Currently, overseas investment is still in the initial phase and on a relatively small scale. FDI registered a rapid increase for years to reach USD60.63 billion in 2004, a y-o-y increase of 13.3%. The other is foreign debt. In the past few years, foreign debt has grown rapidly. By the end of 2004, China's foreign debt reached USD228.596 billion, growing by USD34.962 billion or 18.06% over the previous year-end.

In the absence of an overall monitoring system, short-term capital flows in China may be followed through short-term changes in foreign debt. In recent years, China's short-term foreign debt has risen rapidly in both amount and proportion. By the end of 2004, short-term foreign debt was USD104.309 billion, 45.63% of the total (Figure 2.5).

Figure 2.5 China's Foreign Debt, 1994-2004



Source: SAFE.

The reasons for the increased short-term capital flows are as follows:

First, the considerable interest rate spread between the RMB and foreign exchanges. At present, lending rate varies from 2.5% to 4% in the international market for domestic enterprises. In domestic market, one-year USD lending rate is below 3.5% while that of the RMB lingers between 5.21% and 5.61%. To convert external debt into the RMB or use foreign debt to repay debt in the RMB can save an interest cost of 1.2-3.1 percentage points. Such an interest rate spread between the RMB and foreign exchanges lures foreign companies to borrow more money from foreign banks and incurs the need of the latter to borrow money from overseas, which leads to a rapid growth in foreign debt, especially short-term foreign debt by foreign banks.

Second, the influence of macroeconomic management. Since April 2004, in order to prevent excessive investment in certain industries, China has adopted proactive and effective macroeconomic management measures to keep in check money supply and growth of RMB credit. Given this situation, domestic enterprises—those with foreign investment in particular—are trying to meet their capital needs through overseas financing, so foreign debt rises correspondingly.

Third, greater convertibility of the RMB. Despite a certain degree of control on capital account, convertibility under current account has been realized. Capital under capital account may find its way into the domestic market via current account.

Policies and Measures to Cope with Short-term Capital Flows

On the one hand, measures are taken to effectively bring short-term capital inflows under control. First, capital account liberalization should proceed with a systematic design and orderly implementation. The ongoing domestic financial reform, the relative slowness in fostering a financial market and the imperfect financial regulation and supervision make it all more important to be prudent when it comes to liberalize capital account. Second, improving market mechanism and financial regulation is needed. Third, control of speculative capital inflows should be strengthened. Fourth, improved dynamic monitoring system of short-term cross-border capital flows is desired.

On the other hand, efforts are made to guide capital outflows in a reasonable and orderly manner in accordance with the strategy of "going abroad". First, to further push forward the reform of foreign exchange management of overseas investment and encourage internationally competitive enterprises to "going abroad". Second, to conduct research on the management of overseas credit. Third, to encourage qualified domestic institutional investors such as the foreign exchange funds of insurance companies and social security funds to invest directly in overseas stock markets. Fourth, to strengthen supervision of the internal foreign exchange management of multinational companies.

World Economy and International Finance

The developments and changes in world economies and international finance affect global financial stability, which further affects financial stability in China. Such development and changes therefore deserve close attention.

Current Picture of Global Financial Stability

After a slump of three years, the global economy rebounded in 2004 with a growth rate of 5.1%. The economic growth rate of the US, Japan and the Euro Zone was 4.4%, 2.6% and 1.8%, respectively. In the course of 2005, the US has maintained strong economic growth momentum and its employment environment has improved. The Euro Zone is slowly recovering. Japan's economic growth rate keeps rising steadily, although it has yet to shake off deflation completely. Emerging economies in Latin America and Asia have, on the whole, maintained rapid growth. According to the IMF's forecast in April 2005, global GDP in 2005 will rise by 4.3%. In spite of the inflationary pressures resulting from soaring prices of crude oil and primary products on the world market, the global inflation rate remains low.

The sound international economic and financial situation creates a favorable external environment for global financial stability. The world economy is registering strong growth and financial markets are full of vigor. The asset liability of enterprises, financial institutions and households remains healthy. The global financial system is running steadily. Financial institutions expand and develop themselves by means of mergers, acquisitions and internal restructuring. Mixed operations have become a trend for future financial industries. Financial innovations are making speedy headway.

Since the latter half of 2003, the international financial market has displayed the following features. First, the long-term bond return rate of major industrialized countries rebounded in March 2004, and then went downward at the end of June 2004 when the US Federal Reserve raised interest rates. Second, uncertainties on the money market diminished notably and short-term interest rates rose steadily. Third, capital markets grew swiftly and effectively provided financing services to enterprises; most stock exchanges worldwide went upward with significantly less fluctuations; since the start of 2005, the US stock market has slid while stock markets in the Euro Zone climbed on the whole. Fourth, depreciation of the USD and appreciation of the Euro and Japanese yen still feature the exchange rate of major currencies on the foreign exchange market. Nevertheless, compared with the previous two years, the margin of both depreciation and appreciation considerably narrowed in 2004. In the course of 2005, the USD has posted a stronger performance. Fifth, the scale of international capital flows remains large, and the bulk of which goes to the US to finance its current account deficit.

Risks Affecting Global Financial Stability

Currently, global financial stability faces some potential risks.

Rising US interest rate. Starting from June 2004, the Federal Reserve raised interest rates in ten successive moves to 3.5%, bringing the real interest rate back to positive. The reasons behind this continuous rise in interest rates are first, rising oil prices and greater inflationary pressures; and second, the worsening foreign imbalance of the US and further depreciation of the USD. Further moves by the Federal Reserve to increase interest rates may trigger a major adjustment in global capital flows towards the US while negatively affecting the external financing environment of emerging markets and thus affecting regional financial stability.

Soaring oil prices. Between the 1990s and 2003, the actual price of crude oil swung by around USD20 per barrel. Since the latter half of 2004, crude oil prices began soaring and remained high after it topped USD55 in late October. In July 2005, oil prices lingered at USD50-60. Rising oil prices will not only bring down the import demand of oil importing countries, but also push higher the import prices of oil, leading to higher production costs, greater inflationary pressures, rising export prices and, consequently, have a negative impact on exports and economic growth. The rise in oil prices may also bring down the global economic growth rate. The IMF estimates that the 2005-06 global GDP growth rate will be 0.7-0.8 percentage points lower than that of 2004, with rising oil prices being one major reason.

Imbalance between investment and savings in the US and fluctuations of exchange rate between major currencies. In recent years, global savings and investment are balanced on the whole, but in some industrialized countries, especially the US, there is a considerable gap between savings and investment. In 2004, the savings/GDP ratio in the US was 14%, while the investment/GDP ratio was 20%, a gap of 6% of GDP. The balance, after deducting the factor income in US balance of payments, is basically funded by overseas capital. The savings deficiency of a country is usually reflected as the current account deficit. In the US, the current account deficit/GDP ratio in 2004 was 6%, identical with the savings deficiency/GDP ratio. The US's fiscal deficit and current account deficit indicate both internal and external economic imbalances, and have prompted certain adjustments in the USD exchange rate. Although financial globalization facilitates the US in making up its current account deficit by overseas financing at a lower cost, the US may face greater fluctuations in terms of the exchange rate of the USD against the Euro and Japanese yen, unless it is able to promote economic restructuring at home to address the problem of the "twin deficits" in a timely and effective manner. Besides, the US economy is growing at a higher rate than other developed economies, and this builds up pressure for exchange rate swings among major currencies.

Risk of currency and maturity mismatch confronting emerging markets. New emerging markets generally face the problems of currency and maturity mismatch which gives rise to more financial vulnerabilities. Under the current situation of low interest rates and revaluation of currencies of emerging markets, such a risk will not expose. Once external conditions worsen, the risk is highly likely to lead to financial instability in these emerging economies.

Stalled multilateral trade talks and aggravated global economic friction. On August 1, 2004, the Doha Round framework agreement was reached in Geneva. Nevertheless, as the framework only set out some guiding principles and basic contents for future negotiations, many highly controversial issues were shelved. As the talks proceed, these problems and deep-rooted conflicts will still emerge. Although the failure of the Cancun meeting will not lead to a collapse of the WTO multilateral trade system, its ripple effect will slow down the process of economic globalization. Poor employment drives more international trade protectionism and trade frictions grow instead of diminish. Some countries ascribe the lack of new jobs at home to trade issues, and set up trade barriers in some important fields, augmenting trade frictions between major trade nations. All these are potentially destabilizing factors for financial stability.

Risk of real estate bubble. Since the mid-1990s, property prices in major developed countries have kept climbing, even between 2001 and 2002, when economic growth slowed down. In 2004, property prices in Spain, France and Sweden rose by 17%, 16% and 10%, respectively, while the US property prices were 25%

higher than the average in history. The fact that the boom in the housing market arises to a large extent from internationally low interest rates and excess liquidity, that a considerable portion of individual spending comes from the wealth effect brought by rising property prices, and that housing mortgage loans take up a crucial position in the financial sector determines that drastic modulations in property prices will seriously hit the national economic and financial market, influence the asset quality of the banking system, and impair global financial stability.

The Asian Financial Crisis and risks now existing in international economic and financial development prompt the international community to work for the establishment of a financial stability assessment system. The FSAP, launched by the IMF and the World Bank, is a helpful attempt in this regard.

Box 2 Lessons from the Asian Financial Crisis and Promotion of the FSAP

Before the Asian Financial Crisis, some Asian countries had already revealed some vulnerabilities. First, vulnerability in macroeconomic performance. Rapid economic growth, a low inflation rate, relative fiscal soundness, open capital account, a globalized capital market, an exchange rate regime of formal or informal peg and various incentives from the government attracted huge capital inflows and resulted in a rapid expansion and lower quality of credit and a rise in asset prices. This in turn enabled capital inflows via non-bank financial institutions with weak regulations and supervision and formed a vicious cycle of capital inflows—credit expansion.

Second, vulnerability in the financial sector and corporations. Banks provided loans mainly based on collateral, instead of credit evaluation and cash flow analysis. Therefore, a drop in the asset prices of mortgages led to lower quality of bank assets and threw overwhelming risks on banks. Excessive corporation liability (especially in the Republic of Korea and Thailand) and huge unhedged short-term debt rendered the countries in crisis more vulnerable to market sentiments and changes in exchange and interest rates.

Third, inadequate implementation of prudential regulation and supervision, as reflected by vague standards of loan classification in loans to related parties, concentration of loans, cross-guarantees and currency mismatch as well as a lack of rules on loan provision and interest suspension. In addition, various links between the government and financial institutions made it more difficult to regulation and supervision.

Fourth, poor corporate governance and transparency. Ineffective market discipline indulged too many risky activities. Accounting and information disclosure procedures were far from perfect, and implicit government guarantees undermined market discipline.

The lessons from the Asian Financial Crisis indicate that macroeconomic stability and a healthy national economy cannot be maintained without a sound financial system. There are different ways both in theory and practice to assess the strength and weaknesses of a financial system. On the basis of the lessons drawn from the Asian Financial Crisis, the IMF and the World Bank jointly launched the FSAP in May 1999 to conduct comprehensive assessment and monitoring of the financial systems of the member countries. After several years of development and improvement, the FSAP has become an important supervisory instrument of the IMF, and its member countries have widely accepted its assessment framework. By February 1, 2005, 82 countries and regions have completed the FSAP, 19 countries are conducting the FSAP, and 17 countries have pledged to participate, while 68 countries have not participated or pledged to participate in the FSAP. China has not participated so far.

The FSAP assesses the soundness of a financial system from two perspectives. First, to assess macroeconomic performance and the effect of prudent macroeconomic management. The FSIs are compiled and analyzed to take stock of the vulnerabilities of a financial system and its resilience to losses, while stress testing is carried out to evaluate the impact of a shock on the financial system. Second, to use internationally recognized standards and codes to judge whether the financial infrastructure is complete and financial regulation and supervision effective. Based on the assessment, the IMF and the World Bank then produce a financial soundness report on the economy in question.

In short, the financial stability assessment under the FSAP framework often adopts the following three analytical instruments. (1) The FSIs. The FSIs is a series of indicators compiled by the IMF to monitor the soundness of the financial institutions and market as well as that of their clients (including companies and residents) of an economy. Composed of core and encouraged indicators, the FSIs is used to analyze and evaluate the strengths and vulnerabilities of a financial system. (2) Stress testing which aims at evaluating the linkages between macroeconomic performance and the financial sector, potential risks and vulnerabilities by analyzing the possible impact of changes of macroeconomic variables on financial soundness. (3) Standards and codes assessment. Currently, standards and codes assessment under the FSAP covers nine areas, including the *Code of Good Practices on Transparency in Monetary and Financial Policies*, the *Core Principles for Effective Banking Supervision*, the *Core Principles for Systemically Important Payments Systems*, the *FATF's* 40 + 9 *Recommendations*, the *Objectives and Principles of Securities Regulation*, the *Insurance Supervisory Principles*, the *Principles of Corporate Governance*, the *International Financial Reporting Standards* and the *International Standards on Auditing*. The first four are compulsory items in the assessment.

World Economy, International Finance and China's Financial Stability

In the process of economic reform and market liberalization, China is increasingly influenced by international economic and financial activities, and its financial stability is closely linked to the international environment. Close attention should be paid to the following international economic and financial phenomenon that may influence China's financial stability.

Economic Globalization Adds Uncertainties to China's Financial Stability

Due to an enhanced political and economic status, the international responsibilities and obligations that China shoulders also increase correspondingly. While reaping the benefits of accession to the WTO and participation in economic globalization, China also faces growing uncertainties in financial stability since the rising interconnection between domestic and foreign economic participants, huge flows of capital, commodities, personnel and technology and changes in domestic and foreign policies have made it difficult to effectively control the originally controllable variables in a closed economy.

Major Adjustments in International Economic Structure May Affect China's Financial Stability

Today, the international economic structure is undergoing profound changes. The booming tertiary industry is amassing capital, skilled personnel and technology while the primary and secondary industries suffer a decline in status. If China cannot catch up with this trend, its resources allocation will not be efficient, and this could pose risks to the banking sector as well as the entire financial sector.

Pattern of International Capital Flow Implies Financial Uncertainties

The US is a leading participant in the global financial system. Capital flows between China and the US is greatly influenced by this structure. On the one hand, China holds a current account surplus against the US, and a certain portion of this surplus is used indirectly to finance the US fiscal deficit through purchasing US treasury bonds. On the other hand, attracted by the large domestic demand, cost advantage and profitability in China, quite a lot of US companies are investing in China. The capital flows between China and the US are interdependent and mutually reinforcing. This mode has two characteristics.

First, the return of capital inflows into China is markedly higher than that of the US treasury bonds, which gives rise to asymmetric returns to the Sino-US capital flows. The essence is that the US partially depends on imports from China to bolster its economic growth, and achieve an overall balance of payment through capital inflows, while at the same time makes profits from its investment in China. The highly interdependent capital flows between China and the US could influence the economic and financial stability of both countries.

Second, the US gets increasingly reliant on the investment of foreign exchange reserves by countries such as Japan and China to finance its fiscal deficit. Its swelling current account deficit is mainly financed by its treasury bonds, and its national debt is mainly bought by Asian's central banks, especially Japan's and China's. Such a pattern has become an important pillar for the operation of the international financial market, so any major change that breaks the above-mentioned capital flow pattern, or even a weakening, USD will affect global financial stability and the value of China's foreign exchange reserves and subsequently have a negative impact on China's financial stability.

Interest Rate Hikes in the US and Changes in Exchange Rate Climate May Affect China's Economic and Financial Performance

A significant rise in foreign interest rates may cause considerable changes in the international financial market environment and divert capital out of China to affect the growth of certain industries in China, increase non-performing assets in the banking institutions and render the financial system more vulnerable. Apart from that, exchange rate adjustments of major currencies represented by USD, Euro and Japanese yen have also added uncertainties to a stable RMB exchange rate.

Soaring Market Prices of Crude Oil and Primary Products Put More Inflationary Pressure on China

On the one hand, robust economic growth worldwide triggered rising imports of crude oil. On the other hand, decline of spare production capacity of major oil producers and a market speculation may lead to sustained high prices for oil and other primary products. This could lead to higher inflationary pressure in China.

Besides, the pressure of trade protectionism from China's major export markets such as the US and the EU may have some impact on China's economic growth and financial stability.

Macroeconomic Performance and Liquidity

Macro economy is an important factor that affects the liquidity of financial institutions and financial market. Liquidity of financial institutions is the capacity of these institutions to timely liquidate assets and raise funds through liability; the financial market liquidity is the capacity of the financial market to precipitate financial transactions within a short period of time without causing dramatic fluctuations of asset prices. Liquidity of financial institutions and market to some extent reflects financial stability. If financial institutions can acquire liquidity in time in the financial market, they can avoid both a payment crisis and a slump in financial asset prices. Liquidity of financial institutions and market is the foundation for the financial sector to provide liquidity to other economic sectors, and it influences the soundness of financial performance through payment system. It is an important reference for central banks and financial supervisory authorities in policy making and supervision.

Current Situation of Liquidity of the Financial Institutions and the Financial Market

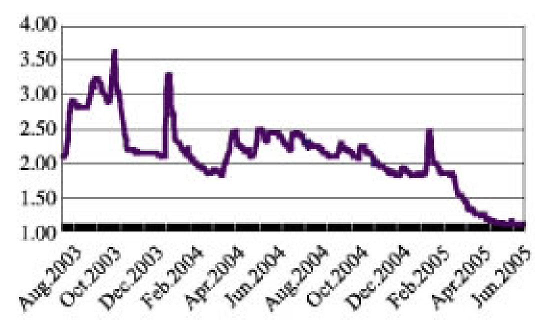
On the whole, liquidity shortage is not a problem for China's financial institutions and the financial market.

Liquidity of financial institutions can be measured by excess reserve ratio. At the end of January 2004, excess reserve ratio of financial institutions was 4.68%. It declined to 3.45% at the end of April and then remained at 3%-4% for seven consecutive months. At the end of December, the figure climbed to 5.25%, with the ratio for SOCBs, JSCBs and RCCs reached 3.54%, 7.47% and 10.34% respectively. In the first half of 2005, excess reserve ratio of financial institutions was kept between 3.3% and 4.4%. At June-end, the figure was 3.72%, 0.03 percentage points lower than the same period in 2004. Adequate liquidity in financial institutions creates an accommodating liquidity environment for reasonable credit growth of commercial banks and product innovation in the financial market and promotes financial stability.

The low level of interest rates in money market manifests ample liquidity in money market. In inter-bank market, bond repo registers the highest turnover. The interest rate for inter-bank pledged bond repo with a maturity of 7 days (R07D) is sensitive to changes in supply and demand of market capital and can more or less reflect the liquidity of money market. In 2004, the R07D interest rate was running low (Figure 2.6). In the first half of 2005, the interest rate of pledged bond repo dropped steadily. The weighted average interest rate of R07D in June was 1.10%, 74 basis points lower than that in January 2005.

Figure 2.6 Weighted Average Interest Rate of 7-Day Repo in the Inter-bank Market between August 2003 and June 2005

(percent)



Source: The PBC.

There are relatively big fluctuations in the stock market liquidity. In the primary market, between 1992 and 2004, listed companies raised a total of RMB845.276 billion yuan from the domestic securities market through A-share and convertible bond issuance and RMB38.295 billion yuan through B-share issuance, thus lifting the aggregate market capitalization of Chinese listed companies from RMB104.813 billion yuan to RMB3705.557 billion yuan. This has resulted in substantial expansion and improved liquidity in the stock market. Nevertheless, since 2005, fund raising in the local stock market has become very difficult, as capital was leaving the stock market due to the prolonged bear market, as well as suspension of new IPOs and other fund raising activities by regulatory authorities worrying about the potential negative market impact. As a result, some blue chips companies turned to overseas listing.

In the secondary market, the average annual turnover ratio of China's stock market in 2004 was 288%, higher than that of other mature stock markets, indicating good liquidity condition in China's stock market. Compared with previous years, however, it shows a tendency of continuous decline due to a prolonged bear market.

In recent years, the growth momentum of institutional investors remained very strong. Currently, there are 156 securities investment funds with 325 billion investment units in domestic market. The pace of QFIIs investing in the domestic stock market is picking up. There are now 27 QFIIs with an USD4 billion approved investment quota. Social security funds, insurance funds and enterprise pensions have also increased their investment in the stock market. Commercial banks have launched their own fund management companies. At the same time, policy initiatives like (1) lifting restrictions on SOEs to buy stocks, (2) allowing fund management companies to borrow with stocks as mortgages and securities companies to issue short-term financing bond, and (3) allowing major shareholders and listed companies to buy back shares, could all improve the stock market liquidity. However, due to the prolonged bear market and loss of previous asset management activities by securities companies, the problems of a number of high-risk securities companies have been exposed, which rendered it significantly more difficult for securities companies to obtain capital. Some securities companies have serious liquidity problems, which in turn create more liquidity pressure on the stock market.

In terms of investor composition, despite the sharp increase in institutional investors, the current market is still dominated by individual investors with about 80% share in terms of stock holding, within which half of them are small and medium investors. Due to the frequent trading of small investors, prolonged bear market could increase the liquidity risk of the stock market.

Macroeconomic Factors Affecting Liquidity of Financial Institutions and the Financial Market

From a macroeconomic perspective, factors affecting the liquidity of financial institutions and the financial market in China are as follows.

First, high M2/GDP ratio. In 2004, facing the hiking CPI and rapid growth of investment in certain industries, Chinese government staged a series of macroeconomic management policies. Under the guidance of these policies, China's economy maintained rapid growth with steady increase in credit and money supply. As one major indicator of liquidity, the M2/GDP ratio reached 190% at the end of 2004 and continued to increase in the first half of 2005, which created conditions for sufficient liquidity in financial institutions and financial market.

Second, continuous increase of deposits in financial institutions. As a major funding source for financial institutions, the growth of deposits has direct bearing on financial institution's liquidity. At the end of 2004, deposits in both RMB and foreign currencies in all financial institutions reached RMB25.3 trillion yuan, a y-o-y increase of 15.3% (RMB3.37 trillion yuan), RMB337.6 billion yuan less than the increase in 2003. RMB deposits reached RMB24.1 trillion yuan, an increase of RMB3.33 trillion yuan over last year, RMB387.1 billion yuan less than the increase in 2003; foreign currency deposits reached USD153 billion, USD4.45 billion increase y-o-y and USD5.98 billion more than the increase in 2003. In the first half of 2005, deposits in financial institutions continued to grow. At the end of June, RMB and foreign currency deposits totaled RMB28.3 trillion yuan, up 16.8% y-o-y. RMB deposits reached RMB26.9 trillion yuan, up 17.2% y-o-y, representing an acceleration of RMB 423.7 billion yuan; foreign currency deposits moved up to USD165.3 billion, a y-o-y increase of 9.4%, representing an acceleration of USD8.6 billion. The continuous increase of deposits in financial institutions enhances their liquidity. It should be noted that the slump in capital market is a significant contributor to increase household savings. The Shanghai Composite Index plummeted by 250 points in 2004 and the slump drove people further towards household savings, resulting in a high savings rate of 49.32% at the end of 2004.

Third, low interest rates in the financial market and low fund-raising cost for financial institutions. Although the PBC adjusted upwards the interest rates of one-year deposits and loans by 0.27 percentage points on October 29, 2004, the real interest rates remained low. Meanwhile, the interest rates in the inter-bank money market remained low throughout 2004, which enabled financial institutions to acquire liquidity in the financial market at a low financing cost.

Fourth, increased short-term capital inflows. The "twin surpluses" of balance of payments and rapid growth in foreign exchange reserves, combined with significant positive spread of interest rates between the RMB and foreign currencies, prompted domestic financial institutions to reduce their overseas asset operations and draw back their capital or to increase overseas short-term loans. Also, foreign hot money entered China through various channels. The increase in short-term capital inflows has further enhanced liquidity in financial institutions and the financial market.

Fifth, development of high-tech industries has augmented the productivity of enterprises, reduced their inventories and the need for working capital. This helped financial institutions to maintain adequate liquidity.

Sixth, due to tightened supervision and awareness, commercial banks tend to be more prudent in lending money, so more funds are entering the money market. In line with the implementation of the macroeconomic management policies, CBRC stepped up financial regulation and supervision in 2004. On March 1, 2004, CBRC launched the *Administrative Measures for the CARs of Commercial Banks* to set up stronger capital discipline for commercial banks, which made commercial banks more prudent in credit activities and resulted in a decline in the credit growth. By the end of 2004, the RMB and foreign currency loans of financial institutions reached RMB18.9 trillion yuan, a y-o-y increase of 14.4%, a deceleration of 7.1 percentage points, comparing to 2003. In absolute terms, outstanding loans increased by RMB2.41 trillion yuan, in 2004, RMB578.5 billion yuan less than 2003. RMB loans increased by 14.5% y-o-y to RMB17.7 trillion yuan, a deceleration of 6.6 percentage points comparing to 2003. In absolute terms, RMB loans increased by RMB2.26 trillion yuan in 2004, RMB482.4 billion yuan less than the increase in 2003. Since the beginning of 2005, credit growth rate continues to decelerate. At the end of June, loans in the RMB and foreign currencies in all financial institutions registered RMB19.9 trillion yuan, up 13.2% y-o-y, of which RMB loans took up RMB18.6 trillion yuan, up 13.3% y-o-y, a deceleration of 3.1 and 1.3 percentage points respectively compared with the end of 2004. Besides, due to limited usage of non-credit assets of commercial banks, their ample fund provides sufficient liquidity for the financial market.

Seventh, the flexible open market operations by the PBC have adjusted the liquidity in the banking institutions to a certain extent. Given the persistent massive increase of base money as a result of foreign exchange purchase in the market by issuing central bank bills, making specific arrangements of the issuance mode, size and maturity structures, taking into account such factors as treasury funds, cash in circulation and bond issuance and redemption which are having impact on market liquidity, these measures help to bring the excessive growth of liquidity in the banking system under control and to prevent it from being too volatile.

Part III

Financial Market and Financial Stability

The financial market is a venue for money and capital to be transacted and allocated. It plays a crucial role in a modern economic system, with key functions: (1) to transfer savings into investments; (2) to provide credit support for consumption and investment; (3) to provide payment mechanisms; (4) to offer investors risk pricing and risk management instruments; (5) to standardize or regulate corporate behaviour through external disciplines and incentive mechanisms; and (6) to offer tools and channels through which the government can implement economic and financial policies.

At present, China has formed a financial market system mainly made up of money market, bond market, stock market, foreign exchange market and gold market, and characterized by: (1) multi-layered trading places; (2) abundant trading products; (3) diversified trading mechanisms. The products involved in trading are mainly stocks, bond, funds, bills, foreign exchange and gold, and comprised many important trading mechanisms such as spot, repo, forwards and futures.

Overall speaking, with rapid development and innovation, stable growth and further improvements in financing structures, China's financial market offered a sound market environment for financial institutions to sustain healthy growth. Fast growing money market with standardized operation greatly improved its asset allocation capability. Bond market also made fast steps in innovation while enjoying a stable growth. Stock market gradually improved amidst reforms and has initially showed the capacity of direct financing. The foreign exchange market has basically taken shape and has become increasingly market-driven. The gold market has made its first step and is gradually increasing its investment functions.

However, developments for various financial markets have been imbalanced. Market function has not yet been fully utilized due to the problems of over-emphasis on indirect financing, the under-developed bond and stock markets together with low penetration in financial market. The *Decision* has pointed out the direction for the reform, opening up and stable development of China's financial market. In next few years, the development of China's financial market will develop according to its domestic needs for a socialist market economy, to establish a transparent, highly efficient and well-structured financial market with healthy mechanism, thorough functions and safe operations, targeting on raising the share of direct financing, establishing a multi-tier financial market system and further utilizing market's fundamental function of asset allocation. To be more specific, efforts should be made to set up an efficient financial market system that helps all types of enterprises to raise funds and meets diversified investment needs; to improve the market-led product innovation means and to form the financial market product mix that gives equal emphasis to price discovery and risk management; to develop accountable market participants and intermediaries with proper operation and comprehensive corporate governance mechanism while emphasizing the restraint and selection system; to establish a market regulatory system that is clearly defined with effective risk control and coordination, to effectively protect the legitimate rights and interests of investors.

Money Market

The money market is a market for short-term—a period of one year or less—financing through short-term financial instruments, including the interbank borrowing market, interbank bond repo market and bills market. Sound development of the money market is the basis on which the central bank can effectively control money supply at an appropriate level to satisfy economic growth.

Current Development

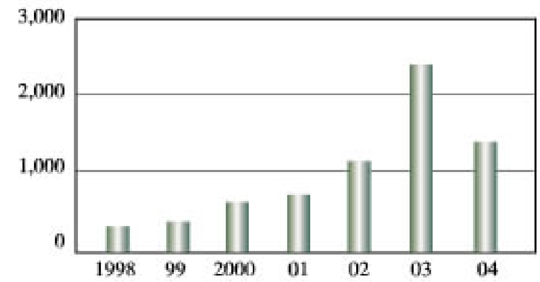
Development of the money market has had the following features in recent years.

First, there was a significant increase in trading volumes in all related sub-markets. The trading volume of the interbank borrowing market has risen from RMB197.8 billion yuan in 1998 to RMB1.46 trillion yuan in 2004, up by 7.4 times (Figure 3.1).

The trading volume in the interbank bond repo market increased from RMB102.1 billion yuan in 1998 to RMB9.44 trillion yuan in 2004, an increase of 92 times (Figure 3.2).

Figure 3.1 Annual Trading of Interbank Borrowing Market

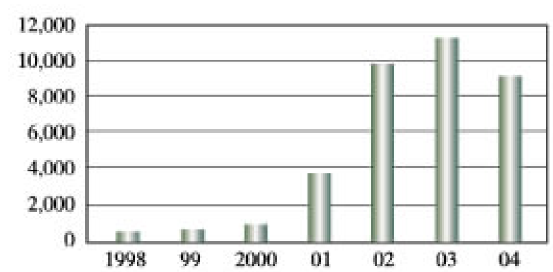
(billions of RMB yuan)



Source: The PBC.

Figure 3.2 Annual Trading of Interbank Bond Repo Market

(billions of RMB yuan)

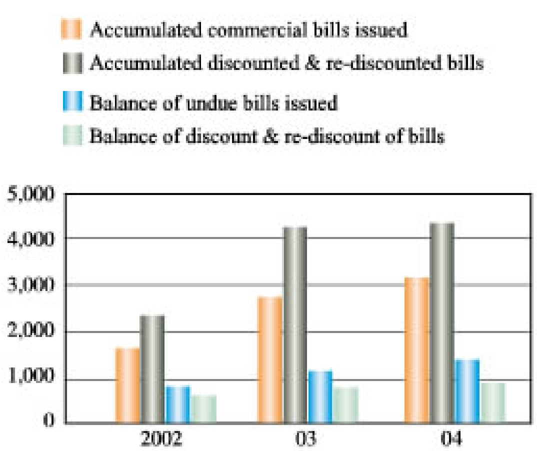


Source: The PBC.

In the bills market, growth in the commercial bills business has remained steady. By the end of 2004, the accumulated value of commercial bills issued was RMB3.4 trillion yuan, representing a y-o-y increase of 22%; discounted and re-discounted commercial bills were valued at RMB4.52 trillion yuan, a y-o-y increase of 1.8%; the balance of undue commercial bills issued was RMB1.5 trillion yuan, a y-o-y increase of 17%; the balance of discount and re-discount of bills was RMB1.003 trillion yuan, a y-o-y increase of 17% (Figure 3.3). The bill operation of the central bank also grows fast. The accumulated value of bills issued by the central bank reached RMB1.51 trillion yuan in 2004, an increase of 93.4% over that of 2003.

Figure 3.3 Bills Market Status, 2002-04

(billions of RMB yuan)



Source: The PBC.

Second, the money market has enjoyed stable growth. Since the interbank borrowing market was established in 1996, with a steady increase in market participants and borrowing volume, a unified national interbank borrowing market has already taken shape, and a market-driven unified interbank borrowing rate (CHIBOR) has also been formed. In addition, a scientific and realistic management structure and supervision pattern has been formed without major breaches. The interbank bond repurchase market has basically covered the whole financial system and is gradually extended to the enterprise level with active trading and a stable rate, which effectively reflected the change in liquidity for financial markets. Disclosure on the interbank borrowing market and the money market also made breakthroughs. In March 2003, 17 finance companies, as market participants, piloted the unified information disclosure standards. In August 2003, the PBC unified the standards for information disclosure by securities companies in the interbank borrowing market.

Third, there was significant progress in capital allocation. The function of short-term position adjustments has won wide recognition. Besides financial institutions such as traditional banks, securities companies and OFIs, enterprises and individuals can access trading through various means, such as settlement agents, and purchasing of money market funds. Diversification of market players has helped to improve the market-oriented formation of CHIBOR and bond repo interest rate, and it further enhances the market-based interest rate system. Interest rates have begun to play their role as a signal to cost of capital, and the interbank bond repo interest rate, in particular, has gained extensive attention as an indicator of the liquidity of the financial market.

Money Market and Financial Stability

As an important means for the central bank to safeguard financial stability, the sound development of the money market has strong implications for achieving financial stability.

First, the financial institutions' ability to avoid liquidity risks has been greatly enhanced. The money market provides participants with cross-period, cross-institution transaction facilities and improves the capabilities of financial institutions to adjust liquidity and defend against liquidity risks. In 2004, interbank borrowing with maturity within seven days recorded a trading volume of RMB1.32 trillion yuan, or 91% of total interbank borrowing volume. For bond repo, the turnover of products with maturity within seven days reached RMB7.53 trillion yuan, or 81% of total repos turnover.

Second, it provides a platform for the central bank to implement monetary policy and maintain currency stability. The well-developed money market provides an environment for the central bank to adjust money supply effectively. The interest rate formed in the money markets is the benchmark for the entire financial market. It is an important operational target as well as a reference to the central bank's monetary policy operation. Money market instruments act as transaction means or references for the central bank to implement monetary policy, which is also an important way to maintain currency stability. Since 1998, open market operations became the most important tool for the central bank's daily monetary policy operations. The central bank has expressed its monetary policy intentions in time through open market operations, effectively sterilized excessive increase of base money as a result of foreign exchange purchase in the market, ensured the steady growth of base money, maintained stable interest rates in the money market, and thus facilitated the smooth implementation of a prudent monetary policy.

Third, it has made interest rates more market-driven and improved the risk management and risk pricing level of financial institutions. Interest rate reforms in China started in the interbank market. At present, the interbank market has basically formed a comprehensive interest rate system, making the interest rate formation mechanism of interbank borrowing and bond repo become more rational. In the money market, where interest rates are set by market forces, financial institutions have gradually enhanced their product pricing capability and showed quicker responses to market information.

Issues and Concerns

Nowadays, sub-markets related to the money market are not developing in a balanced way, and neither are the products, players, intermediaries and rules in the money market. As a result, there is insufficient competition in the money market, which, to a certain degree, has affected the pricing mechanism. To be specific, special attention should be given to the following aspects.

First, trading instruments and products in the money market are inadequate. Currently, available trading instruments in interbank market are limited to interbank borrowing, repo and bank acceptance notes. In the bills market, there are only trading bills, no financing bills. As for bond-type instruments, there are only treasury bond, financial bonds, commercial bank's subordinated debt and a small amount of corporate bonds.

Second, liquidity in the money market needs to be improved. Bond supply and demand, the lack of alternative trading methods and the lack of competitive market intermediaries such as market makers and brokers all contribute to the current low level of liquidity in the market.

Third, over-centralized transactions are unfavourable to competition and pricing mechanisms. In interbank borrowing and repo transactions market, SOCBs are the main source of fund, thus forming monopoly in certain degree. As a result, the competition is insufficient, and the market price formation is affected.

Fourth, there are problems in the operation of the treasury bond repo market in the stock exchanges, especially on the arrangement of custodian business and settlement schemes.

Reform and Development

Further developments in the money market must start with coordination of the market as a whole, with the focus on developing institutions, intermediaries and product innovation.

First, institutions in the interbank borrowing market must be improved. The 1990 *Preliminary Methods on Interbank Borrowing Administration* now in practice hardly meets the needs of market development. The series of administration methods found and tested in market standardization management in recent years need to be confirmed through administrative legislation.

Second, R&D is needed on new money market instruments. Currently, the interbank borrowing transactions of non-bank financial institutions, such as securities companies, dominate the market. Interest rates derived from long-term cooperation between securities companies and commercial banks often diverge from market interest rates. Therefore, we should take the breakthrough from securities companies' issuance of short-term financing bills in the interbank bond market to develop new money market instruments, and gradually change the over-dependence on interbank borrowing by non-bank financial institutions and fully develop the interbank borrowing rate as the signal for market interest rates.

Third, the development of bills market infrastructure should be reinforced. With improvements in cooperation in the credit rating system, operational transparency and accounting standards, we should gradually develop commercial bills based on corporate credit. We should also gradually establish a comprehensive inquiry system for bills business information based on the information system for the interbank borrowing market. Emphasis should be given to the use of modern IT methods in promoting efficiency in the operation of bank acceptance notes. Commercial banks should be encouraged to set up specialized bills operating institutions in a selective manner, which would play the role of market intermediary and help bills business to acquire an appropriate scale of operation.

Fourth, money market brokerage business needs to be promoted, including establishing money market brokerage companies and improving market efficiency.

Fifth, efforts should be made on further progress in the information disclosure system of the interbank borrowing market and the unification of information disclosure standards for all types of financial institutions.

Sixth, to prevent potential risk, enhancing the treasury bond repo market in stock exchanges should be warranted.

Bond Market

The bond market is a market for bond issuance and trading. China's bond market mainly comprises of the interbank bond market and stock exchange bond market. The rapid developments of the bond market not only optimise the financing structure and enrich product investment, but also help to transfer central bank's macroeconomic and financial management from a direct mode to an indirect one.

Current Development

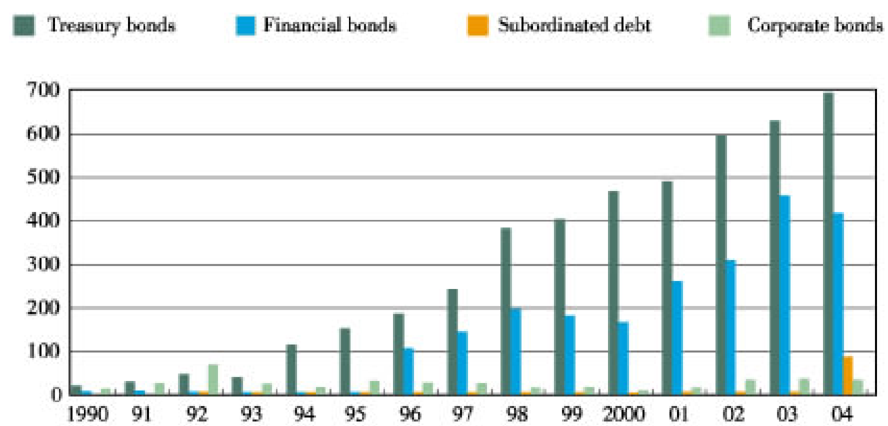
In recent years, the overall bond market has maintained steady growth.

In terms of bond types, the main categories of bonds traded in China's bond market are treasury bonds, financial bonds, subordinated debt and corporate bonds. There are quite a lot trading products in the interbank bond market. By the end of 2004, there were 241 tradable bonds, including 59 treasury bonds, 121 financial bonds, 3 corporate bonds and some subordinated debt issued by commercial banks. The number of treasury bonds traded in the stock exchanges is rising, currently the total number of bonds traded in the stock exchanges reached 155. In 2005, short-term financing bills and bond forwards were launched in the interbank bond market. By July 2005, there were altogether nine short-term corporate financing bills, with a total value of RMB22.9 billion yuan.

In terms of issuance volume, the accumulated issuance of treasury bond was RMB692.4 billion yuan in 2004, a y-o-y increase of 10.3%. Within which, bearer treasury bond issuance was RMB251 billion yuan, a similar scale to that of 2003; book-entry treasury bond issuance was RMB441.4 billion yuan, up 16.9% y-o-y. The accumulated issuance of policy-related financial bonds was RMB414.8 billion yuan, down by 9.1% y-o-y. The accumulated issuance of corporate bonds was RMB32.7 billion yuan, down 8.7% y-o-y. Since July 2004, financial institutions have started to issue subordinated debt in the interbank market to replenish supplementary

Figure 3.4 Bond Issuance

(billions of RMB yuan)



Source: The PBC.

capital, and the accumulated issuance for the year was RMB86.1 billion yuan (Figure 3.4).

In terms of trading volume, accumulated spot transactions in the interbank bond market were RMB2.5 trillion yuan in 2004, a decrease of RMB580.7 billion yuan y-o-y; the treasury bond spot transaction value in stock exchanges was RMB296.6 billion yuan, a decrease of RMB279 billion yuan y-o-y.

Bond Market and Financial Stability

Since the mid-1990s, the emergence and development of a stable interbank bond market has changed the long inferior status of bond market relative to stock market. The establishment of a comprehensive financial market system effectively promoted financial stability, as demonstrated by the following aspects.

First, it has helped to improve the financial market system and promote direct financing. The bond market development has broadened the channels for direct financing, reduced the excessive dependence on the banking system in China's financial structure, relieved the pressure on, and risk to, the banking system to a certain degree and further improved the financial market system.

Second, it has helped to promote the liberalization of interest rate and financial asset pricing. With the market playing a greater role in issuance and trading in the interbank bond market, market-determined bond yield structures and long-term interest rates have begun to emerge in the interbank bond market. The formation of a yield curve for the interbank bond market has provided an important reference and basis for the market pricing of other financial products.

Third, it has helped banks and OFIs to improve liquidity management. The rapid development of the interbank bond market provides banks and OFIs with essential investment instruments and effective asset management methods, which help financial institutions to adjust their liquidity and reduce excess reserves. At the same time, it has helped banks and OFIs to improve liquidity management, enhanced the efficiency of position management, reduced the maturity mismatch and increased profitability, thus created favourable external conditions for the commercial operations of financial institutions.

Fourth, it is helpful to the effective implementation of prudent monetary and fiscal policy. The rapid development of the bond market has provided a solid market foundation for central bank's open market operations and helped the steady growth of base money and the general stability of money market interest rates, thus promoting the smooth implementation of a prudent monetary policy and the transition of monetary policy from direct control to indirect management. Market-determined interbank bond interest rates are crucial to the scientific formulation of monetary policy. At the same time, since 1998, there has been a sharp increase in treasury bond and financial bond issuance in order to implement proactive fiscal policy. The development of the bond market has created conditions for the rise in the scale of issuance of single bond and the shortening of distribution periods, thus improving the efficiency of bond issuance.

Issues and Concerns

Despite considerable progress made in China's bond market, attention should be paid to the following factors.

First, the level of aggregate bond financing is still low, and the product mix is unbalanced. In 2004, new loans by China's banks accounted for 82.9% of the total source of funding of China's financial market, while direct financing, such as stocks, treasury bonds and corporate bonds, accounted for only 17.1%. Meanwhile, internal developments in the bond market are also unbalanced, with relatively fast growth in the treasury bond and quasi-treasury bond markets, while the corporate bond market has lagged behind. In 2004, the total issuance of treasury bond and financial bonds was RMB692.4 billion yuan and RMB414.8 billion yuan, respectively, while that of corporate bonds was only RMB32.7 billion yuan, or 2.7% of the total bond issuance for the year.

Second, the product mix in the bond market lacks variety. In addition to the absence of general financial bonds, municipal bonds and mortgage-backed securities, there is a shortage of risk-hedging derivatives, which often leaves market players more exposed to interest rate risk than they should be. As a result, there is greater fluctuation in the bond market than necessary, which is unfavourable for bond market development.

Third, bond issuance is too concentrated in medium- and long-term bonds, the liquidity of which is insufficient, and the asset pricing mechanism is insufficient. The yield curve has been initially established, but still needs to be improved.

Fourth, a rational credit rating mechanism has not yet been established in the bond market. With insufficient respective rating agencies, their professionalism and independence are generally in doubt. Credit rating for bonds currently hardly offers real insight into the bonds and the risks involved.

Fifth, the existing problems in the accounting and taxation systems also hinder bond market development to some extent. For example, the ambiguous definition of accrued interest of discounted treasury bonds creates difficulty in applying tax-exemption policy, thus affecting the liquidity of these instruments; the lack of clarity in the accounting method and taxation system for buy-out repo of bonds hinders the development of business under this category; and financial innovation also suffers from the absence of an accounting method and taxation policy for financial derivatives.

Sixth, weaknesses in custodian and settlement systems for bonds traded in the stock exchanges has left room for illegal operations by some securities companies.

Reform and Development

Bond market development should emphasize the interbank bond market, with supplementary focus on bond trading in stock exchanges in order to establish a unified, efficient, well-structured and inter-connected bond market by promoting market innovation and improvement in market structure. At the same time, a full interconnection of bond markets should be realized through the flow of funds and information and interconnection of traders and transaction instruments.

First is to actively promote the financial innovation of bond market. Financial innovation should focus on two aspects. One is to increase investors' choices. Efforts should be made to (1) develop the corporate bond market and manage it through market-oriented means, (2) increase subordinated debt issuance by commercial banks and develop the market for general financing bonds by commercial banks , (3) introduce innovation on asset-backed securities and study the feasibility of issuing municipal bonds and local treasury bonds. The other is to deepen market functions in the bond market. Innovation should be based on market conditions, moving from low-risk to high-risk and adopting innovative instruments in a gradual manner. While improving the existing bond forward transactions and buy-out repo, measures should be taken to speed up the introduction of interest rate swaps, bond futures and the other financial derivative products.

Second is the further improvement of the accounting and taxation systems for the bond market. An interactive mechanism between bond market development and the accounting and taxation system needs to be established. Based on international experience, studies of China's bond market accounting and taxation systems should be intensified, especially the accounting system for bond derivatives, to comply with measures for market innovation.

Third is to establish a sound bond credit rating system. With the focus on developing domestic credit rating institutions, certain world-renowned credit agencies should also be introduced to the country. Permission should also be given to Sino-foreign cooperation or restructuring in intermediary services.

Fourth is to regulate bond trading in stock exchanges. Reform should be stepped up in trading, custodian and settlement systems for bonds traded in stock exchanges, to remove the potential risks.

Fifth is to accelerate development of the interbank bond market infrastructure and market operation mechanism. Efforts should be made to speed up the renovation of trading and bookkeeping systems in the interbank bond market, improve the issuance system of the PBC and China Bond Information Network, and enhance related functions. The market-maker system should be improved further, with greater policy support for market makers. More institutional investors should be channelled into the interbank bond market and efforts should be made to nurture qualified institutional investors.

Box 3 Short-term Corporate Financing Bills

On May 23, 2005, the PBC released the *Administrative Rules on the Issuance of Short-term Financing Bills* (referred as *Rules* below), allowing qualified enterprises to issue short-term financing bills to qualified institutional investors in the interbank bond market.

The *Rules* follows the market-orientation principle and has as its main theme all details of development of short-term financing bills, thus providing an important demonstration for the stock market and long-term bond market. Registration and recording system is adopted for market access. The PBC does not make any substantive judgement on issuers, thus reducing administrative intervention and releasing the administrative department from substantive judgement on the issuers. The allowed size of issuance will be determined by the outstanding amount of such bonds, and there will be a maximum ceiling for certain maturity, with no restriction on the interest rate. In terms of issuing methods, market-oriented methods, such as consignment, underwriting and tender, will be adopted. No restrictions are made for the licensing of intermediary services, in order to avoid giving "support" to a selected group of intermediaries through administrative monopoly or recognition. In terms of risk prevention, emphasis is given to the use of market discipline measures, including enforced information disclosure and credit rating, and follows the basic principle of investors' self-judgement and risk-taking. In the development of a short-term financing bill market, the initiative of market players should be guided and mobilized, and the objective rules of market development observed, to develop the market in a market-oriented, orderly and progressive manner by taking advantage of existing conditions.

The adoption of a brand-new financial product—short-term financing bills—in the inter-bank bond market marks a significant breakthrough in diversifying financing channels. It is of strategic importance in expanding direct financing channels at the corporate level, addressing the imbalance between direct financing and indirect financing, sorting out monetary policy transmission mechanisms, preventing M2 from growing too fast, promoting coordinated development between the money market and the capital market, and safeguarding overall financial stability.

The introduction of the short-term corporate financing bills has achieved satisfying results. After the first successful launch of short-term financing bills by Air China Limited and four other companies on May 26, 2005, nine other short-term corporate financing bills were issued within two months, with a total value of RMB22.9 billion yuan. In terms of financing costs, the yield of one-year corporate financing bills was in a range of 2.92%-2.95%, which had a considerable cost advantage compared to an interest rate of 5.58% for one-year loans. In terms of intermediary institutions, the number of main underwriters for short-term financing bills is also increasing.

Stock Market

The stock market is the market for stock issuance and trading. An effective stock market enhances the ability to raise funds, allocate resources, reform corporate operations, establish a modern corporate system and provide investors with a variety of investment and risk-hedging instruments.

Current Development

After 15 years of development, China's stock market has achieved great success and made a significant contribution to the economic and social development of the country. The CPC Central Committee and the State Council have placed great emphasis on the reform and development of capital market. The *Opinions* issued on February 1, 2004 provided the direction for stock market reform and development.

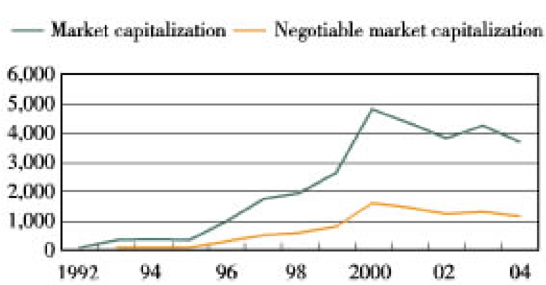
The development of China's stock market can be divided into three stages. During the first stage, from the mid-1980s to 1991, the stock market saw relatively slow growth and was concentrated in the two experimental sites of Shanghai and Shenzhen. The second stage, from the time of DENG Xiaoping's southern tour until early 2004, was a period of comprehensive development, with continuous improvement in infrastructure, legal and regulatory systems, and standardized operations; at this stage, the stock market had already obtained a certain scale and become an important element of the socialist market economy.

The release of the *Opinions* marked the start of the third stage. It was the first document since 1992 providing guidance on the capital market development in the form of a State Council document. Under the leadership of the State Council, various government agencies have taken a series of measures to implement the *Opinions*, including stock issuance system reform, strengthening supervision of listed companies, safeguarding the legitimate rights and interests of public shareholders, standardizing the operation of securities companies, developing institutional invest-ors, enhancing the construction of a basic market framework and promoting product innovation. These measures have further strengthened the market system, helped to prevent and mitigate market risks and laid a solid foundation for the sound development of the stock market.

In 2004, the stock market was mainly stable. The market capitalization dropped in Shanghai and Shenzhen, but the market scale expanded. By the end of 2004, the total and negotiable market capitalization of the two stock markets recorded RMB3.7056 trillion yuan and RMB1.1689 trillion yuan respectively, representing a decline of 12.72% and 11.31% y-o-y (Figure 3.5). The average daily turnover for stocks and funds was RMB17.421 billion yuan, up 30.73% from 2003. The number of investor accounts reached 72.1574 million, up 2.05% from the end of 2003. Total fund-raising reached RMB151.094 billion yuan, an increase of 11.31% y-o-y, of which, IPO fund-raising was RMB35.342 billion yuan, down 22.07% y-o-y (Figure 3.6). Listed companies are expanding in scale with more rational structure and better performance. According to the statistics in the 2004 annual reports published by all listed companies, 1,377 listed companies on the Shanghai and Shenzhen markets had a weighted average revenue of RMB2.474 billion yuan, an increase of 27.11% y-o-y, an average net profit of RMB128 million yuan, up 30.66%, a weighted average EPS of RMB0.25 yuan, up 31.58% y-o-y, and an average net return on assets of 9.12%, up 24.74% (Figure 3.7).

Figure 3.5 Changes in Market Capitalization and Negotiable Market Capitalization of Domestic Listed Companies

(billions of RMB yuan)



Source: Shanghai and Shenzhen Stock Exchanges.

Stock Market and Financial Stability

As a key element of the financial market, the stock market's development plays a significant role in raising the proportion of direct financing, improving financial market structure, promoting enterprise development and safeguarding financial stability.

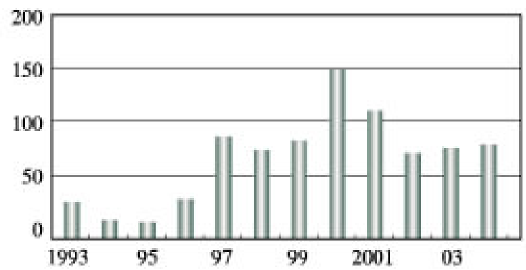
First, raising the proportion of direct financing through development of the stock market will help to establish a more balanced market system. This can ease the over-reliance on bank financing and avoid the situation where financial risks are excessively concentrated in the banking system.

Second, stock market development can improve corporate operations, establish a modern corporate system and enhance the corporate governance structure. Enterprises may raise funds from the stock market to adjust their capital structure to enhance their capacity for sustainable growth. Listed financial institutions can raise funds from the stock market to replenish their capital base, thus improving their capital-adequacy ratio and the ability to handle risk, which also helps to improve financial stability.

Third, a transparent and efficient stock market with proper infrastructure, complete function and sound operation can optimise resource allocation and effectively channel savings into long-term investment, thereby promoting economic restructuring and development. On the other hand, if there are any major problems in

Figure 3.6 Fund-raising by Domestic Listed Companies

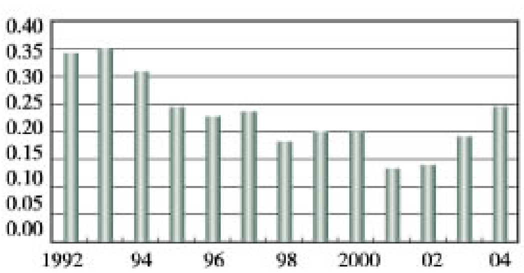
(billions of RMB yuan)



Source: CSRC.

Figure 3.7 EPS of Domestic Listed Companies

(RMB yuan)



Source: CSRC.

the stock market, the risks may spread to other markets and affect overall financial stability.

Issues and Concerns

China's stock market has gradually developed in the process of economic restructuring and reform. Owing to lack of a coherent plan at the initial stage and the limitations of the existing system, there are some structural problems that limit the effectiveness of its functions. Attention should thus be paid to the following aspects of stock market development.

First, the quality of information disclosure needs to be improved. The stock market is an information market, where information disclosed by the listed companies is the basis for investors' investment decisions. Investors can only make rational investment decisions based on their own risk-and-return preferences, if and only if information disclosure fairly reflects company's operations and market risks in a time-sensitive and accurate manner. Currently, inspection and law enforcement needs to be intensified and made more effective in order to crack down on the illegal activities of listed companies, including false accounting and delay in disclosure, improve the quality of listed companies' information disclosure, ensure accountability, accuracy and completeness of information, highlight the importance of pertinence and effectiveness of information, and avoid the formalistic "blank filling" in information disclosure.

Second, the market pricing mechanism needs to be improved. The unique structure of tradable and non-tradable shares creates difficulties in stock pricing. Limited amount of institutional investors and immature investment concepts have yet to exert an influence on market pricing. Intermediaries, i. e., accounting and law firms, and rating and appraisal agencies, need to enhance their professionalism and credibility in order to provide accountable, accurate and timely information. A short-selling mechanism and related risk pricing products have not been introduced. The regulation against stock price manipulation is not effective enough. In short, the pricing mechanism is incomplete, and the market is lacking in pricing capacity.

Third, the non-tradable-share (NTS) problem needs to be resolved entirely. This problem is a historical legacy of the original system design—only one-third of the total shares can be traded on the stock market (tradable shares), with the rest (state-owned shares and legal-person shares) being non-tradable. As a unique problem of share structure, it has long disrupted the development of China's capital market. The existence of non-tradable shares creates difficulty in the formation of a rational stock pricing mechanism and has disturbed the stability of securities market expectations. Without a common interest for corporate governance, major shareholders (holding non-tradable shares) generally have no or little interest in stock price fluctuations, and tradable shareholders thus lose confidence and "vote with their feet". Therefore, an effective control of major shareholders' behaviour by minorities cannot be achieved. This has had a negative impact on state-owned asset management system reform and also hindered the process of internationalisation of the capital market and product innovation. It is fair to say that the existence of non-tradable shares is a major obstacle to the improvement of capital market infrastructure and needs to be addressed in an active and proper manner.

Fourth, the fund raising function is ineffective, with structural problems in products. There are still a lot of subjective judgements in stock issuance supervision, and the division of labour and interconnection between the issuance and listing approval systems are not rational. The limitations on new stock issuance and refinancing have triggered a lot of good Chinese companies to seek listing overseas. This directly affects the development of China's capital market. The performance of the stock market does not match the rapid development of the national economy. The range of tradable products is limited, with a lack of financial futures, index options, stock futures and other derivatives.

Fifth, the quality and operational standards of listed companies need to be further improved. Some listed companies have not completely transformed their management structures, producing poor financial results. They are not entirely law-abiding and involve quite large potential risks. Moreover, the mixture of listed companies is unbalanced. By the end of 2004, large-cap blue-chip companies accounted for less than 10% of listed companies, playing only a limited role in safeguarding market stability and attracting large institutional investors.

Sixth, coherent regulation needs to be applied to securities companies. Certain risks exist among the current securities companies. Some have breached regulations by repurchasing treasury bonds illegally, misappropriating bonds owned by clients, which are placed under their custody, and using customer deposits for securities transactions and settlements in their own proprietary trading, or guaranteeing a minimum return rate to investors in their wealth management business, thus increasing their own operating pressure and risks. Overall, the financial position of securities companies is not strong. In a bear market, the long hidden liquidity risk in securities companies becomes apparent. Since 2004, over ten securities companies, including Southern , Hantang, Minfa and Dapeng, have been closed or put under receivership.

Seventh, further efforts should be put into the development of institutional investors. The limited number of institutional investors makes it difficult to establish investment concepts based on fundamentals or prevent speculative activities. The stocks and financial derivatives from blue-chip companies, which are suitable for large-scale investments, are limited, and the trading system for institutional investors in risk-hedging activities needs to be improved. The evaluation standard for institutional investors including securities investment funds is still imperfect, which has led the institutional investors to take a too short-term view. More work needs to be done to create a favourable tax treatment to encourage enterprise pension funds and social security funds to invest in stocks.

Reform and Development

The essence of the *Opinions* is that the main task of stock market reform, opening up and stable development is to build a transparent, efficient and well-structured market with proper infrastructure, complete function and sound operation aiming at expanding direct financing and fulfilling complete functions, improving the modern market system and expanding the basic role of market in resources allocation. Along this line, it is needed to create an efficient capital market that is able to facilitate fund-raising activities of all types of enterprises and satisfy a variety of investment needs; the market-based product innovation mechanism must be improved to form a capital market product structure that features balance between price discovery and risk management and coordination of stock financing and bond financing; we will develop honest and creditworthy listed companies and intermediaries with standardized operation and proper corporate governance mechanism while emphasizing market discipline and competition; and we will establish a market regulatory system that is clear in role definition, effective in risk control and complete in coordination, to earnestly protect the legitimate rights and interests of investors.

Further Improving Quality and Operating Standards of Listed Companies

The quality of listed companies is the basis for investment value of the securities market. First, we will further improve the stock issuance management system and support competitive companies with standardized operation and a history of good performance to raise funds through IPOs. This will enable us to improve the quality of listed companies from the very beginning. Second, we will actively promote standardized operation of listed companies by constructing a comprehensive regulatory system, setting up a information sharing system on listed company regulation within relevant agencies and strengthening coordination in listed company regulation. Regulation on controlling shareholders, persons with ultimate controlling power of the company and senior management will be strengthened, and law enforcement on activities breaching the regulations will be intensified. Third, the quality of information disclosure by listed companies should be enhanced and false disclosure must be cracked down on. Efforts will be intensified in investigation and law enforcement to improve efficiency and ensure accountability, accuracy and completeness of information disclosure, enhance listed companies' transparency and enable investors to make well-informed investment decisions.

Addressing the NTS Problem in an Active and Proper Manner

Following the basic principle of the *Opinions*, namely that "respect for market principles is positive for market stability and further development, which will effectively protect the legitimate rights and interests of investors, especially public investors", various government agencies have taken steps to address the NTS problem based on principle of "experiments first, coordinated progress and step-by-step settlement". On April 29, 2005, the NTS reform was officially launched. By August 19, 46 companies had completed the regulated reform procedures, thus completing the pilot NTS reform on schedule. The reform principle and methods have won market recognition, and the reform's policy expectation and market expectation have gradually stabilized. The experimental reform has also indicated the direction for the next step, and the NTS reform is ripe for active and proper implementation to all stocks listed in the stock market. On August 23, CSRC, State-owned Assets Supervision and Administration Commission of the State Council, the MOF, the PBC and the Ministry of Commerce jointly issued the *Guidelines on Non-Tradable State Share Reform of Listed Companies*. This document sets out improvements for the system arrangements at the experimental stage by summarising the experiences and anticipating the possible complications of the next stage. The NTS reform should be pushed forward in an active and proper manner.

Firmly Promoting Securities Companies' Risk Management and Reform

In recent years, the hidden risks in securities companies have become increasingly obvious. This reflects serious corporate governance issues. On the basis of full acknowledgement of the actual risk level of securities companies, reform will be focused on the following aspects: specification of measures and responsibilities; handling high-risk companies in a timely and proper manner; adoption of different supervisory mechanisms for different categories of securities companies and the reinforcement of the supervision on senior management and major shareholders; forming an effective regular supervision system and thus to remove the source of risk in terms of institutional building; enhancing integration of sectoral resources, and promoting the development of high-quality securities companies. Currently, the framework of securities investor protection fund has been set up and the risk management system for securities companies has already seen significant progress.

Focusing on Developing Institutional Investors

We will continue to develop securities investment funds, support insurance funds to directly invest in stock market through diversified means, gradually raise the investment in the stock market from social security funds, enterprise supplementary pension funds and commercial insurance capital, and encourage commercial banks to set up securities investment funds. We will develop a group of accountable, law-abiding and professional institutional investors and make the fund management companies and insurance companies a leading force in the stock market.

Institutional investors in the stock market are increasing. With institutional investors playing a greater role in the market, the ability of stock market to evaluate and price assets has been enhanced considerably and positive changes to the concept of investment have occurred. Investors are increasingly attaching importance to the analysis of company performance and long-term investment, the excessive speculation in the market has been effectively reduced and the market exit mechanism is gradually taking shape.

Building A Multi-tiered Stock Market System and Encouraging Market Innovation

First, we will establish a multi-tiered stock market system. We will further regulate and develop the main-board markets, encourage system innovation in the SME board, set up a GEM in phases, improve the Agency Share Transfer System, establish new trading platforms and create the requisite new trading methods, and gradually develop a multi-tiered market system adapted to diversified investment, financing and risk management needs.

Second, we will set up a market-oriented product innovation mechanism, with R&D efforts directed at new stock-related products and derivatives. We will also reinforce the efforts on development of low-risk securities products and provide investors with securities investment products to substitute savings. We will actively explore and develop asset securitization products.

Promoting the Opening up of Securities Markets in an Active and Proper Manner

In compliance with China's WTO commitment to open its securities service industry, we encourage qualified overseas securities institutions to take up shares in China's securities and fund management, introduce advanced overseas management expertise and improve the governance structure and internal control of securities companies. We will continue to encourage qualified overseas institutional investors to invest in the stock market. At the same time, we will actively utilize the overseas capital market, observe market rules and international practice, and support qualified domestic enterprises in their efforts to list overseas.

Improving the Legal System and Credit Building

We will improve the legal system to facilitate the stable development of the capital market and protect the rights and interests of investors, and create a good legal environment for the development of the capital market. In line with the requirement of establishing a social credit system in the modern market economy, we will formulate standards of integrity for the capital market, protect the creditworthiness of the system, and strictly forbid market access to institutions and individuals with a history of serious breaches of laws, regulations or market integrity.

Strengthening Supervision and Cracking down on Breaches of Laws or Regulations

We will improve the supervision system and gradually realize the transformation from a supervision framework focusing on licensing approval and subjective judgements to a supervision framework based on the information disclosure and observance of regulations. We will encourage market self-discipline for institutions and organizations. The regulatory authority will utilize the mechanism of joint investigation and punishment on securities-related crimes with public security authorities to strengthen investigation and judicial enforcement, enhance enforcement efficiency, develop more severe punishment on securities-related illegal activities such as misappropriating the assets of listed companies, false disclosure, insider trading and market manipulation, apply the system of market-access denial, raise the costs of breaching the law, enhance the deterrence and earnestly protect the legitimate rights and interests of investors.

Box 4 Promoting Financial Product Innovation

The innovation of financial products should be a major breakthrough in the overall development of China's financial market, which can enrich financial products and improve the market system.

First, product innovation can enhance the risk-taking capacity of financial institutions and help consolidate the micro foundation of financial stability. The issuance of subordinated bonds helps commercial banks to expand fund-raising channels, improve their CAR and enhance their risk-handling capacity. Issuance of ordinary financial bonds helps commercial banks to strengthen liability management through voluntary liability instruments and ease the mismatch of asset – liability maturities. Asset securitization can improve commercial banks' liquidity position and their capacity against liquidity risks.

Second, financial product innovation enhances transparency in market operation mechanism and strengthens the market discipline mechanism, both of which are helpful for financial stability. The process of financial product innovation is in essence the continuous replacement of non-standardized, low-transparency and low-liquidity financial products by standardized, high-transparency and highly liquid ones. It is usually accompanied with the improvement of market rules and strengthening of market discipline. In a process of new product introduction, market discipline mechanisms including compulsory information disclosure, credit rating and creditor agent are constantly improved, which is favourable for setting up a market-selection mechanism that supports the good and restricts the bad.

Third, financial product innovation can improve financial structure and macro environment for financial stability. Introducing new direct financing instruments and developing new institutional investors can gradually correct the imbalance between direct financing and indirect financing, and thus ease the risk concentration in the banking system. The development of new institutional investors such as money market funds and the introduction of money market brokers will gradually improve the financial market structure and help reduce destabilizing factors in the financial market.

Fourth, overseas institutions have developed financial futures products related to China's market, but outside of the country's jurisdiction in recent years. This has added to the urgency for innovative financial products development within China. Financial globalization has made the competition for financial resources among countries more severe than ever. To protect state financial safety and promote the orderly progress of financial product innovation, it is necessary to formulate long- and medium-term financial development strategies to make a broad plan to develop a financial derivatives market, which could satisfy the investment and risk-hedging demand of the citizens and institutions.

In recent years, the increasing level of financial product innovation with market order formation has steadily improved a coordinated and sustained growth of the financial market. Financial product innovation is active in the money market and the capital market. Commercial bills, repo, medium- to long-term treasury bonds, corporate bonds, close-ended funds and open-ended funds have been introduced. The formation of market order for innovative financial products has also made significant progress: the formulation of the *Administration Methods for Financial Debt Issuance in the National Interbank Bond Market* further expanded bond issuers' scope; the *Administrative Rules on the Issuance of Short-term Financing Bills* has expanded the channels for corporate direct financing; the *Regulations on Administration of Bond forward Transactions in the National Interbank Market* enhanced mobility of bond market; the *Preliminary Methods for Administration of Money Market Funds* promoted fund business development in the money market; the *Provisions on Administration of Outright Bond Repo Transactions in the National Interbank Bond Market* and the *Master Agreement of Outright Bond Repo Transactions in the National Interbank Bond Market* further enriched trading instruments in the bond market; the *Preliminary Methods on Administration of Warrants in Shanghai Stock Exchange* and the *Preliminary Methods on Administration of Warrants in Shenzhen Stock Exchange* made a useful experiment on introducing warrant products; the *Detailed Rules for Implementation of ETF Business of Shanghai Stock Exchange* and the *Detailed Rules for Implementation of LOF Business of Shenzhen Stock Exchange* introduced new types of funds, such as ETF and LOF, thus further expanding the fund market and strengthening institutional investors.

In the near future, we should accelerate the innovation of financial products. Within the bond market, we should develop the corporate bond market, expand the scale of subordinated bond issuance by commercial banks, introduce new basic products such as general financial bonds, international development organization bonds and asset-backed securities. In terms of financial derivatives, we should gradually introduce interest rate swaps, foreign exchange swaps and other new products in light of market development.

While speeding up the financial product innovation, we should take further measures to regulate the new products and prevent financial risks. We should encourage financial institutions to strengthen internal risk control, evaluate potential risks of new products and enhance the capacity to detect and prevent high-tech crimes. We should improve the accounting standards and promote information disclosure in line with international standards to improve transparency. Financial supervisory authorities should also exercise power over newly developed products to effectively fend off financial risks.

Foreign Exchange Market

The foreign exchange market refers to the market in which buyers, sellers and intermediaries purchase and sell foreign currencies. Its main function is to determine exchange rates and settle the supply of and demand for foreign currencies.

Current Development

The foreign exchange market in China is divided into two parts: one is a market in which companies conduct their foreign exchange transactions with designated foreign exchange banks; the other is the nationwide interbank foreign exchange market.

In China, the foreign exchange needs of individuals and enterprises are mainly satisfied through purchasing and selling of foreign exchanges to designated banks according to the prevailing exchange rate.

The nationwide interbank foreign exchange market is a market in which financial institutions, authorized by the SAFE to conduct foreign exchange businesses, engage in RMB and foreign currency transactions through the Chinese Foreign Exchange Trading Center. The Center provides a platform for transaction in the interbank foreign exchange market.

Since 1994, the RMB exchange rate has been determined under: (1) a mandatory foreign exchange purchase and sale arrangement for corporations and individuals; (2) a regime whereby quotas are imposed upon turnover positions of foreign exchange purchase and sale for designated foreign exchange banks; and (3) the open market operation of the central bank. When the fluctuation of the RMB exchange rate against the USD is close to or reaches the upper and lower limits, the PBC will step in to purchase and sell foreign currencies through an open market operation to balance demand and supply.

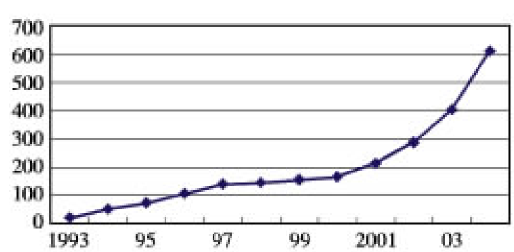
The establishment of interbank foreign exchange market in 1994 put an end to fragmented markets and multiple exchange rates, laying a foundation to a unified and managed floating exchange rate regime based on market demand and supply. Over the last decade, China's foreign exchange market has enjoyed rapid development with an increase of transaction volume from USD40.8 billion in 1994 to

USD209 billion in 2004. The RMB has appreciated from 8.7 yuan to one USD in 1994 to 8.2765 yuan to one USD at the end of 2004.

Meanwhile, foreign exchange reserves have increased steadily, reaching USD609.9 billion by the end of 2004, compared to USD21.2 billion at the beginning of 1994. Rapid increase of base money as a result of foreign exchange purchase has become a major channel of the central bank's creation of base money (Figure 3.8). To ease inflationary pressure from increase of base money as a result of foreign exchange purchase, the PBC adopted hedging policy by increasing the required reserve ratio and the issuance of central bank bills to absorb liquidity.

Figure 3.8 Changes in Foreign Exchange Reserves

(billions of USD)



Source: SAFE.

Since July 21, 2005, the PBC has carried out a series of measures to further improve the formation mechanism of RMB exchange rate regime in an active, controllable and gradual manner. These measures included: improvement of the central bank's market operation; increasing the flexibility of the RMB exchange rate, i.e. shifting from a USD peg to reference to a basket of currencies; reducing the administrative control toward foreign exchange proceeds and expenditure to expand market foundation for exchange rate regime, i.e. gradually increasing the retention quota for an enterprise's foreign exchange proceeds under current account, further increasing quota for individual purchase of foreign currency and simplifying the foreign currency purchase and sale certificate process; enhancing market infrastructure development; optimising functions of foreign exchange market, such as addition of trading entities in the foreign exchange market, diversification of trading methods, and increase of trading products, etc.

Through a series of policies and arrangements, the PBC has increased the flexibility of the RMB exchange rate, allowing the market to play a greater role in the formation of the exchange rate regime. In addition, these policies serve as instruments to prevent risks, and allow the foreign exchange market to play a greater role in asset pricing, effective resources allocation and risk management. Policies governing foreign exchange in China have become more market-oriented. In addition, they are part of the efforts to achieve the overall objective of a market-based managed floating RMB exchange rate regime with basic stability of the exchange rate at an adaptive and equilibrium level.

Foreign Exchange Market and Financial Stability

The current RMB exchange rate is derived from trading among market participants in the interbank foreign exchange market. Since China's foreign exchange market operation started in 1994, there has always been an excessive supply of foreign currencies, which required the central bank to increase foreign exchange reserves through open market operation in order to maintain a stable RMB exchange rate. Given this feature, the central bank has increased its efforts to optimise RMB open market operations in a more flexible fashion in terms of level and timing. As a result of regulating the liquidity in the banking system at the appropriate time and with proper intensity, the central bank has been able to control the supply of base money at a proper level as a result of foreign exchange purchase. The central bank's efforts to regulate the market have played a decisive role, and have become an important force to maintain the stability of foreign exchange rate and the market.

Since 2002, RMB exchange rate has become an international focus. To maintain RMB stability at an adaptive and equilibrium level benefits not only the sustainable economic development and financial stability of China, but also the neighbouring countries and regions and even the global economy and financial system. Efforts should be made to develop, standardize and improve foreign exchange market to better the formation mechanism of RMB exchange rate regime. The development of foreign exchange market should be in line with China's economic growth, the state of the economy, international balance of payment and reforms in other fields in order to maintain stability of the RMB exchange rate at an adaptive and equilibrium level .

Issues and Concerns

Since the foreign exchange rate regime reform in 1994, China's foreign exchange market has enjoyed stable development, which has played a fundamental role in the stability of the RMB exchange rate. However, in comparison with developed foreign exchange markets overseas, the width and depth of China's foreign exchange market is still limited. The market function has not been fully played out. Attention should be given to the following aspects.

First, small market size. In 2004, the trading volume of foreign exchange reached USD209 billion for the full year, accounting for only 18% of China's external trade, in sharp contrast with average daily trading volume of USD1.9 trillion in the global foreign exchange market in 2004.

Second, limited market entities. By the end of 2004, there were 354 participants in China's interbank foreign exchange market. Designated foreign exchange banks made up the majority of these, and very few non-bank financial institutions and other types of market participants were allowed to participate.

Third, centralized trading. Trading volume of the four SOCBs accounts for major share of the interbank market transactions.

Fourth, limited RMB trading products. Current trading products of RMB are limited to only four currencies: USD, Euro, Hong Kong dollar and Japanese yen.

Fifth, inadequate risk-hedging instruments. The only financial derivative instrument that currently exists is the one-year forward transaction. Other financial derivatives like futures, options, and swaps do not exist, which means China's system is unable to satisfy the risk-hedging demand from corporations.

Reform and Development

The reform and development of China's foreign exchange market will follow a gradual manner which is consistent with RMB exchange rate and interest rate reforms as well as the development of economy and financial market. Emphasis will be on competitiveness, efficiency, cooperation and risk management.

First, expanding trading categories and volume in the foreign exchange market. Based on the current development of the domestic foreign exchange markets, efforts will be made to increase innovative new products and services to meet market demand. On the basis of improvements on spot market, further efforts should be made to cultivate the forward markets: to promote pilot project of forward purchase and sale, to establish forward foreign exchange market, and to explore financial instruments such as foreign exchange forwards, currency swaps, options, and futures to prevent risks.

Second, research on the introduction of a market-making system for tradings involving the USD. Currently, the trading system in interbank foreign exchange market in China is dominated by one-way quoting and bidding system, in which the lowest selling price and the highest buying price are matched. The low liquidity under the current transaction mechanism creates the need to develop a market-making system that incorporates commercial banks with financial strength and good credibility. The two-way quoting mechanism of the market-making system could improve the liquidity and operational mechanism of the foreign exchange market. At the same time, the PBC could intervene in China's foreign exchange market through market makers. A market-making system could adjust the purchasing and selling prices when necessary according to the transaction trend and dynamics in the market, and change the price gap to improve the market price formation mechanism.

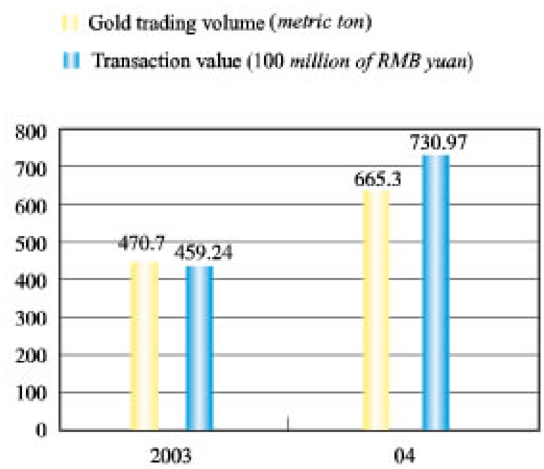
Third, promote electronic trading. Efforts will be made to continuously upgrade the electronic trading systems and study the trend of electronic brokering in the world to integrate China's foreign exchange trading system with international practice, to establish partnerships with major international foreign exchange markets including New York, London, Paris and Tokyo, and to open up China's foreign exchange market by following international experiences.

Fourth, balance the supply and demand relationship. Efforts will be made to increase the ratio of voluntary foreign exchange purchase and sale to relax the limits imposed on the purchase of foreign currencies by enterprises and individuals. Adjustment on turnover position of foreign exchange purchase and sales will be made to regulate supply and demand in the foreign exchange market.

Gold Market

The gold market is the market in which buyers and sellers purchase and sell gold. The establishment and development of the gold market in China help to enrich investment products, and improve market system, monetary policy instrument and macroeconomic management system.

Figure 3.9 Gold Trading Volume, 2003-04



Source: The PBC.

Current Development

On October 30, 2002, the establishment of Shanghai Gold Exchange put an end to the planned management system of monopolising the purchase and allocation of gold. Since then, reform of the gold market has accelerated, and a market system has been put in place with Shanghai Gold Exchange as the major trading platform. Over-the-counter transactions at commercial banks constitute the supporting system. The operation of China's gold market has the following characteristics:

First, the market size has expanded. In 2004, 665.3 metric tons of gold were traded in China, an increase of 35.6% y-o-y, with a transaction value of RMB73.097 billion yuan, a y-o-y increase of 59.2%. (Figure 3.9)

Second, market participants have diversified. Besides traditional producers of precious metals and buyers for jewellery production and industrial purposes, commercial banks also participate. Commercial banks play a stabilizing role, adjusting market supply and demand between cyclical lows and peaks through the international markets, which effectively eases the supply and demand mismatch and facilitate gold production, circulation and consumption.

Third, investment function has been enhanced. The diversification of market participants has prompted transformation of gold value from usage to investment. The remarkable improvement of market investment function provides multiple profit-making channels for investors.

Gold Market and Financial Stability

The development of the gold market is also helpful in maintaining financial stability, through the following aspects.

First, the development of gold market helps to set up multi-layered financial markets and change the current situation where capital is over-centralized in banks. This can ease the pressure on banks to some extent and help to maintain financial stability.

Second, the development of the gold market also benefits macroeconomic management. From the central bank's perspective, the development of the gold market is helpful to improve monetary policy instruments and macroeconomic management system. Under the modern financial system, gold still has a strong currency characteristic. Since the breakdown of the Bretton Woods System, the currency function of gold has weakened to some extent, but the fluctuation of the gold price is still an important benchmark for central banks around the world to judge inflation. Furthermore, central banks around the world still use a considerable amount of gold as national reserves. Gold reserves together with foreign exchange reserves and the IMF reserves form a nation's international reserves, which also serve the function of risk hedging. The development of China's gold market helps to provide solid and effective micro-foundation for macroeconomic management.

Third, the development of the gold market also facilitates the transformation of savings to investment. Since gold is a commodity that combines the features of a currency and general commodity, it is an instrument for wealth storage as well as risk hedging. Thus, we could transfer savings to investments by turning the high domestic savings from currency assets to gold assets through the gold market development.

Issues and Concerns

Starting from scratch, China's gold market has enjoyed substantial development. In the future, attention will be paid to the following aspects.

First, efficient and safe gold trading system and risk management mechanism need to be strengthened. In order to avoid potential risks and ensure smooth transaction, strict definition of open position and risk estimates associated with bidding should be made in order to control the overall transaction risk.

Second, trading products in the gold market need to be diversified. At the moment, the only trading mode at Shanghai Gold Exchange is spot transaction. This single transaction method fails to meet the demands of different investors.

Third, integration with the global market needs to be realized. At present, the gold market in China is relatively closed. Specifically, market participants are limited to domestic gold producers, consuming enterprises and commercial banks. Free import and export of gold has not been realized. 24-hour synchronous transaction execution with the global market is not yet in place.

Reform and Development

The development of the gold market in China is aimed at establishing a safe and highly efficient gold transaction system, which can fully utilize the risk-hedging function of the gold market. Given this, efforts will be made in the following aspects to promote the development of China's gold market.

First, efforts will be made to facilitate the transformation of gold transaction from sole commodity transaction to mixed transaction between commodities and financial products. Development of personal gold investment operations will be treated as a breakthrough to reinforce the product innovation. In addition to the launch of T + 5, deferred delivery and other new products, we should continue to build the basic framework of a financial product trading system with risk-hedging function, thus making trading products having commodity attributes, and putting in place a sound financial product trading system.

Second, derivative trading will be promoted. Under the prerequisite of forestalling financial risks, gold derivatives business including forwards and futures will be gradually introduced to meet the demand of investors to hedge risks, and to provide diversified investment instruments, enriching the selection of trading products available in the market.

Third, integration with global market will be accelerated. In the near future, China's gold market will be opened up further, and integration with the global market will be accelerated. Gold is an international product. China will consider introducing international competitive price-setting banks, foreign banks and famous gold mining enterprises to participate in trading in order to build solid foundation for globalization of China's gold market.

Box 5 Attention and Guidance to Informal Financing

Informal financing refers to borrowing and lending activities of natural persons, non-financial entities and organizations that do not fall under the scope of state laws of financial regulation and policy adjustment. Informal financing is a concept relative to official or institutional financing. State approved borrowing and lending is regarded as official financing, and the remainder is informal financing. At present, informal financing in China takes many forms, such as borrowing and lending, mutual assistance community, underground banks, and private equity funds.

Due to insufficient financial market and inadequate financial products, as well as constraints stemming from concerns regarding financial liberalization and risk rating capacities of financial institutions, SMEs and peasants in many parts of China are facing difficulties in getting access to official financing.

Informal financing is convenient for them. At current stage, the existence and development of informal financing activities is generated by reality, and it also supports SMEs and rural economic growth.

Informal financing has its own natural advantages in its specific area. First, given the location, occupation and personal relationship, informal financing naturally obtains an informational advantage. Second, informal financing has a more flexible guarantee system, which helps to lift the constraints faced by poor peasants and SMEs, as many guarantees in the informal financing market cannot be used as guarantees in official markets. There is also a social guarantee mechanism in the informal financing market. Other than credit relationship, the borrower and lender are bound by social relationships. To a certain extent, this kind of social relationship is an intangible asset, which could bring material and psychological benefits, constituting the basis for social guarantee. Under the social guarantee mechanism, borrowers are subject to additional penalties other than economic penalties, which set further constraints to the borrowers' behaviour. In addition, low transaction cost is another advantage of informal financing.

However, we must realize that the above advantages exist only in a relative term, as informal financing activities are only practical within a relatively small area, which reflects the disadvantages on size and scope of the informal financing. Without adequate guidance, the informal financing could be abused by criminals to engage in financial fraud and other activities, which disrupts financial order and stability. The private financing society established in Fu'an City in Fujian Province is a typical case.

Supervision and guidance should be exercised in order to enable informal financing to play its role in regions and fields with underdeveloped financial services.

First, proper guidance should be provided to informal financing in a case-specific manner that encourages its positive role in economic development and discourages its negative impact on financial stability.

Second, we should differentiate treatments towards rational informal financing activities and illegal financing activities. We would gradually provide policy supports to rational informal financing activities and guide them toward open and standardized operations. At the same time, financial fraud that jeopardizes the economy, disrupts social and financial stability, and illegal solicitation of public funds will be penalized under law in order to safeguard financial stability.

Third, while providing guidance, we would gradually relax limitations imposed on informal financing, allowing private capital to engage in financial services under certain conditions. At the same time, we should speed up the development of financial system in the rural area and guarantee system for SMEs and encourage the development of small- and medium-sized financial institutions, which involve the shareholding of private capital investment.